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6 July 2012

Ms Anita Sit
Clerk to Panel
Panel on Financial Affairs
Legislative Council Secretariat
Legislative Council Complex
1 Legislative Council Road
Central, Hong Kong
(Fax: 3529 2837)

Dear Ms Sit,

Inland Revenue (Amendment) (No. 3) Ordinance 2011

The Inland Revenue (Amendment) (No. 2) Bill 2011 was passed by the Legislative Council on 7 December 2011, and it was gazetted on 16 December 2011 as the Inland Revenue (Amendment) (No. 3) Ordinance 2011 (“the Amendment Ordinance”). In response to the request by the relevant Bills Committee, the Administration now provides for reference by the Panel on Financial Affairs an advance copy of the Departmental Interpretation and Practice Note (“DIPN”) (see Appendix) drawn up by the Inland Revenue Department (“IRD”) pursuant to the provisions of the Amendment Ordinance.

2. IRD will issue the above DIPN on 10 July 2012.

Yours sincerely,

A handwritten signature in black ink, appearing to be 'Fiona Chau', written over a circular stamp or mark.

(Miss Fiona Chau)

for Secretary for Financial Services and the Treasury

Encl.



Inland Revenue Department
Hong Kong

DEPARTMENTAL INTERPRETATION AND PRACTICE NOTES

NO. 49

**PART A : PROFITS TAX DEDUCTION OF CAPITAL
EXPENDITURE ON RELEVANT INTELLECTUAL
PROPERTY RIGHTS**

**PART B : TAXATION OF ROYALTIES DERIVED FROM
LICENSING OF INTELLECTUAL PROPERTY
RIGHTS**

These notes are issued for the information of taxpayers and their tax representatives. They contain the Department's interpretation and practices in relation to the law as it stood at the date of publication. Taxpayers are reminded that their right of objection against the assessment and their right of appeal to the Commissioner, the Board of Review or the Court are not affected by the application of these notes.

CHU Yam-yuen
Commissioner of Inland Revenue

July 2012

DEPARTMENTAL INTERPRETATION AND PRACTICE NOTES

No. 49

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INTRODUCTION

Background

1. As an incentive to step up technological innovation in local industries, section 16E was added to the Inland Revenue Ordinance (Cap. 112) (“the Ordinance”) in 1983 to provide deduction for the capital cost of acquiring patents, trade marks or designs. This deduction is additional to that for royalty or recurrent payment in connection with the use of intellectual property rights (“IPRs”) under section 16(1), and that for capital expenditure relating to the registration of trade marks or designs, or the registration or grant of patents under section 16(1)(g).
2. As a measure to prevent exploitation, section 16E was amended in 1992. One amendment was to withdraw the deduction for “trade marks” and “designs” and substitute by “know-how” which was confined to industrial information and techniques on manufacturing of goods. Another amendment was to deny deduction for transactions between associated parties. Since then, only the purchase cost of patent rights and rights to any know-how are deductible under section 16E.
3. Nowadays, innovation and application of technology are the most effective ways to add value to products and services. To promote wider application of IPRs by local enterprises and to facilitate the development of creative industries in Hong Kong, the Financial Secretary proposed in the 2010–2011 Budget that profits tax deduction should be extended to cover capital expenditure incurred on the purchase of three types of commonly-used IPRs, namely, copyrights, registered designs and registered trade marks (“the Specified IPRs”).
4. In December 2011, the Legislative Council passed the Inland Revenue (Amendment) (No. 3) Ordinance 2011 (“the 2011 Amendment Ordinance”) to implement the above budget proposal. The purpose of this Practice Note is to set out in detail the Department’s views and practice on the profits tax deduction relating to the purchase of patent rights, rights to know-how, copyrights, registered designs and registered trade marks (hereinafter collectively referred to as “the Relevant Rights”) following the enactment of the 2011 Amendment Ordinance.

2011 amendments to section 16E

5. Given that the nature of patent rights and rights to know-how is similar to the Specified IPRs, opportunity was taken to modify the provisions in the then section 16E. In this regard, the 2011 Amendment Ordinance includes three major amendments to section 16E and they are further discussed below.

To remove the “use in Hong Kong” condition

6. With the globalisation of the world economy, business activities are no longer confined to Hong Kong. On this premise, the “use in Hong Kong” condition imposed by section 16E(1) on the deduction for patent rights and rights to any know-how is removed. In other words, capital expenditure on the purchase of patent rights and rights to any know-how would be deductible irrespective of whether they are used in Hong Kong so long as other deduction conditions are satisfied and that the deduction is not otherwise precluded under the provisions of section 16EC.

To cap the sales proceeds that should be brought to tax

7. Before the enactment of the 2011 Amendment Ordinance, the full amount of sales proceeds would be brought to tax upon sale of the patent rights and rights to know-how for which deductions have been previously allowed. However, this is not in line with Hong Kong’s policy of not taxing capital gains. As such, section 16E was amended to the effect that the sales proceeds of patent rights and rights to know-how to be brought to tax should not exceed the deductions previously allowed (section 16E(3)).

To specify legal expenses and valuation fees as deductible expenditures

8. For the avoidance of doubt, section 16E(1A) was added to provide explicitly that deduction would be available under section 16E(1) for legal expenses and valuation fees incurred in connection with the purchase of patent rights and rights to any know-how.

9. It should be noted that the above amendments are also applicable to the Specified IPRs. The effective dates of these amendments are further

discussed in paragraphs 68 to 70.

Taxation of royalties

10. The Department takes the view that whether royalties derived from the licensing of IPRs, other than those deemed chargeable under section 15(1)(a), (b) and (ba), are chargeable to tax in Hong Kong depends on the facts and circumstances of each case. For illustration purposes, paragraphs 73 to 75 give some general examples on the application of the broad guiding principle to ascertain the source of royalty income.

PART A : PROFITS TAX DEDUCTION OF CAPITAL EXPENDITURE ON RELEVANT INTELLECTUAL PROPERTY RIGHTS

THE RELEVANT RIGHTS

11. IPRs are intangible assets with no physical form. They are the exclusive rights offered by law to people to protect their creations. The application of IPRs in business operations and products will bring economic benefits. Following the enactment of the 2011 Amendment Ordinance, deduction is provided for capital expenditure to acquire patent rights, rights to any know-how, copyrights, registered designs and registered trade marks.

12. The guiding principle is that deduction would be provided as long as it is substantiated that the right concerned constitutes one or more of the Relevant Rights. Thus, in determining whether a right falls within the scope as defined by the Ordinance, the Department would make reference to the relevant statutory registration regime, where one exists, which provides an effective means to ascertain the nature of the Relevant Right concerned (i.e. a patent, a registered design or a registered trade mark). If a registration system does not exist for the Relevant Right in question (i.e. know-how or copyright), the relevant agreement for sale and purchase will be examined so as to ascertain the precise nature of the subject matter sold or purchased.

Patent rights

13. A patent gives its inventor and owner a legal right to prevent others from manufacturing, using, selling or importing the patented invention. A patent is, in effect, a limited property right that a jurisdiction grants to the inventor in exchange for his agreement to share the details of the inventions with the public. A patent being an exclusionary right must be “registered” with the jurisdiction of such right. Section 16E(4) of the Ordinance defines “patent rights” to mean “*the right to do or authorize the doing of anything which would, but for that right, be an infringement of a patent*”. Thus, any invention not registered with the jurisdiction does not fall within the term “patent rights” and it is pertinent that deduction will only be allowed for the purchase cost of patents which have already obtained the grant from the

relevant authorities.

Rights to any know-how

14. Trade secrets, also described as “know-how” or “show-how”, are protected commercially by maintaining security within the business enterprises and by the use of confidentiality agreements. There is no statutory registration for them. The term “know-how” is defined in section 16E(4) to mean “*any industrial information or techniques likely to assist in the manufacture or processing of goods or materials*”. By virtue of this definition, the deduction is confined to trade secrets and confidential information which are related to manufacturing process.

Copyrights

15. For the purposes of sections 16EA, 16EB and 16EC, “copyright” means:

- (a) a copyright within the meaning of section 2(1) of the Copyright Ordinance (Cap. 528), including an unregistered corresponding design as defined by section 87(5)(b) of that Ordinance; or
- (b) any right that subsists under the law of a place outside Hong Kong in any work in which a copyright referred to in paragraph (a) may subsist and corresponds to a copyright referred to in paragraph (a).

According to the Copyright Ordinance, “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 patents, designs and trade marks, there is no registration regime for copyright works in most of the jurisdictions including Hong Kong.

Registered designs

16. For the purpose of sections 16EA, 16EB and 16EC, the term

“registered design” means “*a design registered under section 25 of the Registered Designs Ordinance (Cap. 522) or under the law of any place outside Hong Kong*”. Under the Registered Designs Ordinance, a “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. Designs registered under the Registered Designs Ordinance enjoy the protection afforded by that Ordinance in Hong Kong.

Registered trade marks

17. “Registered trade mark” is defined in section 16EA(11) to mean “*a trade mark registered under section 47 of the Trade Marks Ordinance (Cap. 559) or under the law of any place outside Hong Kong*”. Under the Trade Marks Ordinance, 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. A trade mark serves as a badge of trade origin. Registration for trade marks provides legal protection in the jurisdictions or territories where they are registered. Trade marks are registered for use in one or more specific classes of goods and services.

DEDUCTION ALLOWABLE

18. Paragraphs 19 to 33 below set out the conditions that must be satisfied to support a deduction claim in respect of a Relevant Right.

Registration requirement

Patents, registered designs and registered trade marks

19. The Relevant Rights have to be registered where a registration system is in place, namely patents, designs and trade marks. For the other two IPRs, i.e. know-how and copyrights, no registration is required. Hence, to

qualify for deduction, a patent must have been granted or registered with the relevant authorities while a design or trade mark must have been registered, on the date of acquisition.

Registration in Hong Kong or overseas

20. Capital expenditure incurred to acquire any Relevant Rights registered in Hong Kong or overseas will qualify for deduction. So long as the registration of a Relevant Right was in force during a part or the whole of the basis period of a year of assessment, deduction will be allowed provided that the other prescribed conditions are fulfilled.

Registration of assignment in process

21. In order to protect their interest in the Relevant Rights, it is common for taxpayers to submit application to the relevant registration authorities for registering the assignments of the Relevant Rights. Recognising that the registration process of the Relevant Rights in some jurisdictions may take some time to complete, the Department will adopt a liberal approach in considering deduction for those Relevant Rights undergoing registration process. In this regard, a Relevant Right undergoing the registration process would also be accepted for claiming deduction. For the Relevant Rights which have a registration system in place (i.e. patents, registered designs and registered trade marks), deduction would be allowed for the capital expenditure incurred on the purchase of the Relevant Rights on the conditions that –

- (a) the Relevant Rights have already been registered by the previous owners with the relevant authorities; and
- (b) the taxpayers have already submitted applications for registering the Relevant Rights under their names.

22. To summarise, as long as a taxpayer, when applying for deduction for capital expenditure incurred on the purchase of a Relevant Right, could provide documentary evidence to substantiate that all the conditions for deduction have been fulfilled, including that the registration of the Relevant Right has been effective from a date not later than the day on which the taxpayer purchased the Relevant Right, the taxpayer will be granted the deduction. However, if a taxpayer's application for change of ownership is not eventually approved by the relevant authority, the Relevant Right is not

eligible for deduction. The Department will raise additional assessment under section 60 of the Ordinance as appropriate to disallow any deduction previously allowed.

Invalidation, revocation and surrender

23. When the registration of a Relevant Right is subsequently invalidated, revoked or surrendered, the Relevant Right concerned will not be eligible for the deduction from the date when the invalidation, revocation or surrender becomes effective. The Department would, in accordance with section 60 of the Ordinance, make additional assessment as appropriate to disallow any deduction previously allowed.

Legal and economic ownership

Outright purchase

24. If a deduction is to be allowed, a taxpayer must possess both the legal and economic ownership (or proprietary interest) in the Relevant Right that he has purchased. That is, deduction would only be applicable to an outright purchase of a Relevant Right and not to an upfront fee paid for acquiring the right to use the Relevant Right for a specified period. In the generality of cases, where a taxpayer only obtains the use of a Relevant Right granted by the owner (as licensor) under a licensing arrangement, the taxpayer (as licensee) would not have acquired the legal ownership in the Relevant Right concerned.

License of Relevant Rights

25. It is put beyond doubt in the 2011 Amendment Ordinance that any expenditure incurred on the acquisition of a “licence” of a Relevant Right is not deductible (sections 16E(9) and 16EA(13)). In this regard, a “licence” in relation to a Relevant Right is defined in section 16EC(8) as –

- “(a) ... a licence (however described and whether general or limited) authorizing the licensee to use the relevant right in the manner authorized by the licence; but*
(b) does not include an agreement under which the ownership

of the relevant right will or may be sold to or pass to the licensee unless, in the opinion of the Commissioner, the right under the agreement to purchase or obtain the ownership of the relevant right would reasonably be expected not to be exercised’.

26. On the other hand, expenses relating to the licensing of Relevant Rights may be deducted under the normal deduction rules under sections 16(1) and 17 of the Ordinance, i.e. the expenses are deductible if they are incurred in the production of chargeable profits of the taxpayer and that they are not capital in nature.

Example 1

Company HK obtained the right to use a Relevant Right from the owner by way of a 10-year licence. The consideration included an upfront payment of \$1,000,000 for the grant of the licence and an annual licence fee of \$100,000. Since Company HK has not acquired the legal ownership of the Relevant Right, it is not entitled to the deduction under section 16E or 16EA for whatever payments made under the licensing arrangement. Nevertheless, the annual licence fee of \$100,000 which is revenue in nature is deductible under the general deduction provisions of section 16(1). However, the upfront payment in the amount of \$1,000,000 which is capital in nature would be prohibited for deduction under section 17(1)(c).

Relevant Rights which are self-created

27. If a taxpayer develops its own IPRs in the ordinary course of its business and where there is a separate and identifiable project for the development of the particular IPR, which would bring future economic benefits to the business, such capital expenditure is likely deductible under section 16B as expenditure on research and development (“R&D”). Please refer to paragraphs 2 to 21 of Departmental Interpretation and Practice Notes No. 5 for details. Nevertheless, insofar as the IPR is a Relevant Right, no deduction is allowable for such expenditure under section 16E or 16EA because the owner and creator has not incurred expenditure to purchase the Relevant Right.

Example 2

Company HK purchased a patent registered in the United States and subsequently conducted R&D in Hong Kong by using that US patent to create a new invention. Since registration and protection of patents operate on a territorial basis, if Company HK wants to enjoy protection in Hong Kong, it should apply for registering the US patented invention and the other new invention in Hong Kong. The capital expenditure incurred on the purchase of the US patent will be deductible under section 16E if it is used for the production of chargeable profits. However, no deduction under section 16E can be allowed for the new invention that is patented in Hong Kong because it is self-created and not purchased by Company HK from others. The R&D expenditure in relation to the new invention may be deductible under section 16B provided that the prescribed conditions are fulfilled.

Relevant Rights which are partly owned

28. A taxpayer having partial ownership of a Relevant Right is also eligible to claim for the deduction so long as he has a share or interest in the Relevant Right. In the generality of cases, a taxpayer's share or interest is proportionate to the capital expenditure that he has incurred. For these cases, the deduction for each taxpayer is computed with reference to the amount of capital expenditure that he had incurred in acquiring the Relevant Right.

Example 3

Company HK-1 and Company HK-2 acquired a Relevant Right at a consideration of \$100,000. Their respective shares in the legal ownership of the right are 30% and 70% and the respective capital expenditure incurred are \$30,000 and \$70,000. The amounts of deductible expenditure available to Company HK-1 and Company HK-2 will be \$30,000 and \$70,000 respectively.

In the case where a taxpayer acquires only a partial share of the legal ownership in a Relevant Right from the original owner, the taxpayer will be granted for the amount of capital expenditure incurred by him for acquisition of such share in the ownership of the Relevant Right. If it happens that a

taxpayer has incurred expenditure that is excessive when comparing with his share or interest in the Relevant Right, IRD may substitute the true market value for the stated consideration, after considering all the relevant circumstances of the case.

Requirement of “use”

29. There is, under the Ordinance, no definition of the word “use”. According to the Shorter Oxford English Dictionary, the word “use” means *“the action of using something; the fact or state of being used; application or conversion to some purpose”*. In relation to the Relevant Rights, the word “use” has its ordinary meaning which encompasses licensing of the Relevant Rights.

30. The Department will, having regard to the nature of the Relevant Rights and the relevant facts of individual cases, determine if the taxpayers concerned have “used” the Relevant Rights for production of chargeable profits. If taxpayers can prove to the satisfaction of the Department that they have carried out concrete steps in relation to the use of the Relevant Right for production of chargeable profits, the Department would accept that the taxpayers have fulfilled the requirement.

In the production of chargeable profits

31. To be eligible for deduction, the Relevant Rights have to be used in producing profits chargeable to tax in Hong Kong. Whether a Relevant Right is used in the production of chargeable profits is a matter of fact and evidence. For example, a taxpayer purchased a Relevant Right which has been registered in ten jurisdictions but he only used the Relevant Right in four jurisdictions and claims for deduction of the expenditure to acquire the Relevant Right in respect of all the jurisdictions, on the ground that the purpose of purchasing the Relevant Right in the six other jurisdictions is to protect the registration of the Relevant Right in the four jurisdictions where the Relevant Right is used. The Department would accept the above claim only if the taxpayer could provide substantive and reasonable evidence to prove that the Relevant Right registered in the six jurisdictions has direct and actual impact on the production of profits chargeable to tax in Hong Kong.

Summary of deduction criteria

32. In summary and subject to the exclusion provisions as discussed in paragraphs 53 to 67 below, deduction for the purchase cost of a Relevant Right will be granted to a taxpayer if, during a part or the whole of the basis period for a year of assessment –

- (a) the Relevant Right subsists (in the case of copyrights or rights to know-how) or, if applicable, the registration of the Relevant Right is in force (in the case of patent rights, designs or trade marks);
- (b) the taxpayer possesses the legal and economic ownership of the Relevant Right at the end of the basis period;
- (c) the Relevant Right has been used in Hong Kong or by the taxpayer himself outside Hong Kong; and
- (d) the Relevant Right has been used for production of profits chargeable to tax in Hong Kong.

33. For capital expenditure on the acquisition of copyrights, registered designs and registered trade marks which deduction will be spread over five succeeding years (see paragraphs 37 and 38 below), each of the five years of assessment will be considered separately and the conditions in paragraph 32 above will need to be satisfied for each of the years of assessment concerned.

Example 4

Company HK purchased a Mainland registered design which was used on products sold by it in the Mainland and the profits are chargeable to profits tax in Hong Kong. Company HK is eligible to claim deduction for the purchase cost of the registered design in the year of purchase (over five years of assessment) because: (i) the design was registered in the Mainland and was in force where it was used; (ii) Company HK possessed the legal and economic ownership of the registered design at the end of the basis period; (iii) the registered design has been used by Company HK itself in the Mainland; and (iv) the registered design has been used for production of profits chargeable to tax in Hong Kong.

Example 5

Company HK purchased a trade mark at a total consideration of \$1,000,000 which has been registered in Hong Kong and the US from a US company. The Hong Kong registered trade mark and US registered trade mark are valued at \$600,000 and \$400,000 respectively. In the year of purchase (i.e. Year-1), sale of the branded goods were made to Hong Kong customers only. In the following year (i.e. Year-2), Company HK set up a branch office in the US for sale of the branded goods to US customers. The profits derived by the US branch office is chargeable to Hong Kong profits tax.

In Year-1, since the Hong Kong registered trade mark was wholly used for sale of the branded goods in Hong Kong, the deduction allowable is \$120,000 [i.e. \$600,000 ÷ 5]. No deduction for the US registered trade mark is allowed as it has not been used at all.

In Year-2, Company HK used the US registered trade mark for the production of chargeable profits. The deduction allowable in respect of the US registered trade mark is \$80,000 [i.e. \$400,000 ÷ 5]. In respect of the Hong Kong registered trade mark, the deductible amount is the same as in Year-1, i.e. \$120,000. Hence, the total allowable deduction in Year-2 is \$200,000 [i.e. \$120,000 + \$80,000].

QUALIFYING EXPENDITURE

Legal expenses and valuation fees

34. Capital expenditure incurred on the purchase of a Relevant Right is deductible and it includes legal expenses and valuation fees incurred in connection with the purchase of that right. However, no deduction will be granted for any expenditure which is allowable as a deduction under any other section of the Ordinance.

Capital expenditure incurred prior to commencement of business

35. Where a taxpayer incurs capital expenditure on the purchase of a

Relevant Right for the purposes of a trade, profession or business which is about to commence, the expenditure is to be treated as if it has been incurred on the first day on which the taxpayer carries on the trade, profession or business (sections 16E(3A) and 16EA(10)).

WHEN ALLOWABLE

One-off deduction in the year of purchase

36. For patent rights or rights to know-how, a full deduction is allowed when the expenditure is incurred. There is no requirement that the patent or know-how, once acquired, must be used in the production of chargeable profits in the year of purchase. It is sufficient if the taxpayer claiming the deduction can show that at the time of purchase the purpose of acquiring the patent or know-how was for use in the trade, profession or business carried out in Hong Kong. However, adjustment of the deduction may have to be considered if the subsequent facts prove otherwise.

Deduction over five succeeding years

37. For copyrights, registered designs or registered trade marks (i.e. the Specified IPRs), the deduction should be spread over five succeeding years on a straight-line basis starting from the year of purchase (section 16EA(3)). For example, if a registered trade mark is purchased by a taxpayer but is only put to use in the 4th year after the year of purchase, the taxpayer could not claim deduction for the portion of the capital expenditure spread over for the years before Year-4. Only the portion of capital expenditure spread over for Year-4 and Year-5 would be allowable provided that all the deduction criteria are fulfilled. In the extreme case where a taxpayer acquired a Specified IPR which is not used until five years after its purchase, no deduction will be granted to the taxpayer.

38. If the Specified IPR is a copyright or a registered design and is due to expire at the end of its maximum period of protection before the expiry of the basis period for the last of the five succeeding years of assessment (i.e. the Specified IPR reaches the end of its finite life within the prescribed 5-year spread-over period), the deduction is to be spread over the years of assessment

from the year of purchase to the year in which the right expires in equal instalments (section 16EA(4)).

Example 6

Company HK purchased a copyright at a consideration of \$400,000. The maximum period of protection for which the copyright could subsist is due to expire in the 4th year after the year of purchase. The deductible amount is to be spread over the four years of assessment in equal amount, that is, \$100,000 [i.e. $\$400,000 \div 4$] for each of the four years of assessment provided that the other deduction criteria are fulfilled for each of the years of assessment concerned.

Example 7

If the maximum period of protection for which the copyright in Example 6 could subsist is due to expire in the year of purchase, the purchase consideration of the copyright, i.e. \$400,000 will be fully deductible in the year of purchase provided that the other deduction criteria are fulfilled.

VALUATION OF THE RELEVANT RIGHTS

Commissioner's power to determine the true market value

39. It is essential for the proper computation of the deduction allowable that the Relevant Rights purchased by taxpayers are correctly valued. In the normal course of event, it is the duty of the taxpayer who wishes to claim a deduction of the capital expenditure on a Relevant Right to state the same in his tax return. He is not required to attach the valuation report when filing the tax return. However, for the purpose of ascertaining the taxpayer's correct tax liability, the Assessor may, as it deems necessary, request the taxpayer to provide documentary proof such as valuation report, if available, to substantiate the claim. The Commissioner is empowered to determine the "true market price" for any sale or purchase of any Relevant Right if he is of the opinion that the consideration does not represent the true market value of that Relevant Right at the time of that purchase or sale (sections 16E(8) and 16EA(9)).

40. As the term “true market value” is not defined in the Ordinance, the Commissioner has to resort to its ordinary meaning. In general, it means the price at which a willing buyer and a willing seller would transact, with each party having access to all relevant information and with neither party under the compulsion to transact. This is in line with the Australian High Court decision in *Spencer v. The Commonwealth of Australia (1907) 5 CLR 418*, in which the following principles were recognised –

- (a) the willing but not anxious seller and purchaser;
- (b) a hypothetical market (i.e. if there is no market for the asset being valued, the valuer is to assume a market);
- (c) the parties being fully informed of the advantages and disadvantages associated with the asset being valued; and
- (d) both parties being aware of current market conditions.

Valuation reports

41. The valuation report provided by the taxpayer is the starting point for the Commissioner to determine the true market value. For warranted cases, the Commissioner may seek separate valuation from independent professional valuers on the “true market value” of the Relevant Right concerned.

Relevant Rights purchased or sold together with other assets for a single price

42. Where a Relevant Right is purchased or sold together with other assets for a single price, the Commissioner is empowered to allocate the purchase price of the Relevant Right having regard to all the circumstances of the transaction (sections 16E(7) and 16EA(8)).

Rights of objection and appeal

43. If a taxpayer disagrees with the Commissioner’s valuation or allocation of consideration in respect of a Relevant Right, he can object to the profits tax assessment in which the valuation or allocation is adjusted. The objection will be processed in accordance with the relevant provisions under Part XI of the Ordinance.

APPORTIONMENT OF RELATED CAPITAL EXPENDITURE

General principle

44. If a Relevant Right is purchased for use partly in the production of chargeable profits and partly for any other purposes, the deduction allowable in relation to the capital expenditure incurred shall be the extent of the use of the Relevant Right in the production of the chargeable profits (sections 16E(2) and 16EA(7)). In making an apportionment, the objective is to find a basis which is reasonable and appropriate in the circumstances of the case, including the terms of the agreement relating to the Relevant Right, the manner and the use to which the Relevant Right is put, the range and scope of the activities both within and outside Hong Kong and whether the whole of the profit is subject to tax in Hong Kong.

45. For example, a Hong Kong enterprise purchased a trade mark which is affixed to goods for sale to Hong Kong customers. At the same time, the Hong Kong enterprise granted the use of that trade mark to its fellow subsidiary in Hong Kong for free. Thus, the trade mark is only partly used by the Hong Kong enterprise in the production of chargeable profits. An adjustment for the non-allowable portion should be made and the appropriate apportionment is to be decided depending on the particular circumstances of the case.

Basis of apportionment

46. Obviously the circumstances of the case will determine the most suitable method. It is not possible to lay down any hard and fast rule and it will be for the taxpayer who is claiming the deduction to justify his claim and the basis of apportionment adopted. In practice, the method used to apportion will depend on the individual circumstances of the case.

SUBSEQUENT DISPOSAL

Sale of the Relevant Rights

47. Where a patent or know-how in respect of which a deduction has

been allowed is sold, the relevant proceeds of sale, not otherwise chargeable to profits tax and not exceeding the amount of deduction previously allowed, will be treated as a trading receipt (section 16E(3)).

48. Section 16EB(2) provides that where a Specified IPR (i.e. copyright, registered design or registered trade mark) for which a deduction has been allowed is sold –

- (a) if the unallowed amount of the Specified IPR exceeds the relevant proceeds of sale, the excess will be deducted in the basis period during which the sale occurs; or
- (b) if the relevant proceeds of sale exceed the unallowed amount of the Specified IPR, or if there is not an unallowed amount, the excess or the relevant proceeds of sale, as the case may be, not otherwise chargeable to profits tax and not exceeding the amount of deduction previously allowed, will be treated as a trading receipt.

Relevant proceeds of sale

49. The term “relevant proceeds of sale”, in relation to patent rights or rights to know-how (section 16E(4)) or Specified IPRs (section 16EB(3)) in respect of which a deduction has been allowed, means –

- (a) if the rights are used wholly in the production of chargeable profits, the proceeds of sale of the rights; or
- (b) if the rights are used partly in the production of chargeable profits, such part of the proceeds of sale of the rights as is proportionate to the extent to which the deduction has been allowed.

50. Where only part of the cost of such rights has been allowed, only that part of the proceeds as is attributable to the relevant cost of the rights will be assessed as a trading receipt. The basis of apportionment of the sale price will depend on the facts of each case. The sale proceeds will be treated as a trading receipt accruing at the time of sale, or immediately before the discontinuance if the sale occurs after the business has been permanently discontinued (sections 16E(3) and 16EB(2)).

Example 8

Company HK purchased a patent at the cost of \$500,000 during the year of assessment 2011/12 (the company closes its accounts on 31 March). The patent was used partly in the production of chargeable profits and the allowable proportion is 50%. Deduction of the patent cost in the amount of \$250,000 (i.e. \$500,000 x 50%) was allowed in the year of purchase. During the year of assessment 2012/13, Company HK sold the patent for \$200,000. The relevant proceeds of sale are \$100,000 (i.e. \$200,000 x 50%). Since the relevant proceeds of sale do not exceed the deduction previously allowed (i.e. \$250,000), it is deemed as a trading receipt for the year of assessment 2012/13.

Unallowed amount

51. Under section 16EB(3), the term “unallowed amount”, in relation to a Specified IPR (i.e. copyright, registered design or registered trade mark) in respect of which a deduction has been allowed and which is subsequently sold, means –

- (a) if the Specified IPR is used wholly in the production of chargeable profits, the amount of specified capital expenditure incurred in relation to the Specified IPR that is still unallowed as at the time of sale; or
- (b) if the Specified IPR is used partly in the production of chargeable profits, such part of the amount referred to in paragraph (a) above as is proportionate to the extent to which the deduction has been allowed.

Example 9

Company HK purchased a registered trade mark for \$2,000,000 during the year of assessment 2011/12 (the company closes its accounts on 31 March). The registered trade mark was used partly in the production of chargeable profits and the allowable proportion is 50% and 60% for the years of assessment 2011/12 and 2012/13 respectively.

Deduction of the purchase cost in the amount of \$2,000,000 would be

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allowed and spread over in equal amounts of \$400,000 (i.e. \$2,000,000 ÷ 5) for the five succeeding years of assessment starting from 2011/12 and up to 2015/16. For the years of assessment 2011/12 and 2012/13, the allowable deduction is proportionate to the extent of the use of the registered trade mark in the production of chargeable profits as follow –

<u>Year of assessment</u>	<u>Purchase cost to be spread over the 5-year deduction period</u>	<u>Percentage of use</u>	<u>Allowable deduction</u>	<u>Deduction not allowed</u>
	[1]	[2]	[3] = [1]x[2]	[4] = [1]-[3]
2011/12	\$400,000	50%	\$200,000	\$200,000
2012/13	<u>\$400,000</u>	<u>60%</u>	<u>\$240,000</u>	<u>\$160,000</u>
Total	<u>\$800,000</u>	<u>55%</u>	<u>\$440,000</u>	<u>\$360,000</u>

The total allowable deduction for the first two years is \$440,000. The extent to which deduction has been allowed over the first two years is 55% [i.e. \$440,000 ÷ \$800,000].

During the year of assessment 2013/14, Company HK sold the registered trade mark for \$3,000,000. The relevant proceeds of sale are \$1,650,000 [i.e. \$3,000,000 x 55%]. The unallowed amount is \$660,000 [i.e. (\$2,000,000 - \$800,000) x 55%] which is less than the relevant proceeds of sale. The deemed trading receipt is \$990,000 [i.e. \$1,650,000 - \$660,000] but is restricted to \$440,000 [see section 16EB(2)(b)].

Example 10

The facts are same as Example 9 except that the trade mark is sold for \$1,000,000. The relevant proceeds of sale are \$550,000 [i.e. \$1,000,000 x 55%]. The unallowed amount is still \$660,000 [i.e. (\$2,000,000 - \$800,000) x 55%] which is greater than the relevant proceeds of sale. The excess of \$110,000 [i.e. \$550,000 - \$440,000] will be deductible in the year of assessment in which the trade mark is sold, i.e. 2013/14 [see section 16EB(2)(a)].

DEDUCTION NOT ALLOWED UNDER CERTAIN CIRCUMSTANCES

52. To counteract arrangements to exploit the generous deductions, provisions were introduced in the 2011 Amendment Ordinance which are outlined in paragraphs 53 to 67 below.

Purchase of the Specified IPRs by licensors with early termination of licence – a transitional provision

53. Section 16EC(1) provides that no deduction is allowable in respect of any Specified IPR purchased by a taxpayer if –

- (a) at any time before the commencement date of 16 December 2011 (“the Commencement Date”) of the 2011 Amendment Ordinance, the Specified IPR had been used by the taxpayer under a licence the expiry date of which fell on or after the Commencement Date;
- (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.

54. This provision aims to prevent the licensor and the licensee of a Specified IPR from abusing the 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 receipts, whereas the licensee enjoys the benefit of accelerated deduction (one-off or 5-year straight-line deduction vis-a-vis annual deduction over the whole licensing period).

55. The Department takes the view that termination of the licence of a Specified IPR for the purpose of section 16EC(1) includes termination by implied agreement between the parties or by operation of law. Nevertheless, this anti-avoidance measure would not be applicable to a genuine transaction where the purchase price of a Specified IPR is, in the opinion of the Commissioner, reasonable consideration for acquiring the proprietary interest

of the Specified IPR. Factors influencing the Commissioner's decision include –

- (a) reasons for entering into such a transaction between the licensee and the licensor;
- (b) the terms and conditions agreed between the parties concerned;
- (c) the basis of computation for the purchase price of the Specified IPR; and
- (d) whether there is an option for the original owner to buy back the Specified IPR.

56. Section 16EC(1) is a transitional measure and would not be applicable to taxpayers who have become licensees of the Specified IPRs on or after the Commencement Date and purchased the same rights before the expiry dates of the relevant licences. At the time when the taxpayers enter into the licensing arrangements, they already have the option to enjoy the deduction if they choose to purchase the proprietary interest of the Specified IPR. Hence, the Department would normally regard that there is little, if any, tax motive for the taxpayers to turn the licensing arrangements into sale and purchase arrangements before the expiry dates of the relevant licences.

Purchase of the Relevant Rights from associates

57. By virtue of section 16EC(2), no deduction is allowable if the Relevant Rights are purchased wholly or partly from an associate, irrespective of whether or not the price is at an arms-length. The meaning of “associate” is widely defined in section 16EC(8). It covers natural persons, partners in a partnership, or corporations under common control and trusts.

58. In the case of a trust, the purchase or sale of a Relevant Right by the trustee of the trust or a corporation controlled by the trustee would be regarded as the purchase or sale, as the case may be, by each trustee, the corporation and the beneficiary under the trust (section 16EC(3)).

Sale and license back arrangement

59. Under section 16EC(4)(a), deduction would not be allowed for a sale

and license back of a Relevant Right. The denial of deduction is intended to prevent an overall tax benefit being obtained through this kind of tax avoidance schemes.

60. In general, the reference to “taxpayer” in section 16EC(4)(a) connotes the licensor (or owner) who has incurred capital expenditure on the purchase of the Relevant Right which is under licensing. The party which is ultimately granted the right to use the Relevant Right is described as the “end-user”, who is either –

- (a) the licensee, either alone or with others, or
- (b) an “associate” of the licensee.

For this purpose, the term “associate” has been defined widely in section 16EC(8) in order to prevent circumvention of the provisions by the interposition of third parties.

61. Section 16EC(5) is a carve-out provision excluding genuine commercial financing arrangements from the anti-avoidance provisions. This exception applies in the situation where –

- (a) the selling price of the Relevant Right does not exceed the previous purchase price paid by the end-user (section 16EC(5)(a));
- (b) the Relevant Right was purchased by the taxpayer on or after the Commencement Date (section 16EC(5)(b)); and
- (c) no deduction in respect of the purchase cost of the Relevant Right has been made to the end-user before (section 16EC(5)(c)).

This exception is added so that taxpayers with a need to purchase new Relevant Rights can still obtain finance through sale and license back arrangements, without being hindered by the anti-avoidance provisions. The carve-out provision is not applicable to the Relevant Rights purchased before the Commencement Date.

Example 11

Company HK-L is a leasing company whereas Company HK-M is a manufacturing company. Both companies are carrying on business in Hong Kong. Company HK-L owned a registered trade mark. Before the

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Commencement Date, Company HK-L after revaluing its registered trade mark sold it to Company HK-M. Company HK-M in turn licensed the registered trade mark back to Company HK-L for royalties. Company HK-M would be denied deduction in respect of the purchase of the registered trade mark under section 16EC(4)(a) because the registered trade mark was owned and used by Company HK-L prior to acquisition. The exception in section 16EC(5) did not apply because Company HK-M purchased the registered trade mark before the Commencement Date and the conditions under section 16EC(5)(b) are not fulfilled.

Example 12

Company HK-L purchased a copyright for \$1,000,000. Before putting it into use and claiming any deduction, Company HK-L sold the copyright to Company HK-F which licensed the copyright back to Company HK-L for an annual fee of \$110,000 for a period of 10 years. By virtue of the sale and license back arrangement, Company HK-L obtained cash proceeds of \$1,000,000 which was the price he paid the original owner. Assuming each instalment contained an effective finance charge of \$10,000 whereas the market interest should have been \$20,000, Company HK-L in effect transferred the deduction to Company HK-F in return for a lower rate of interest. The conditions in section 16EC(5) are satisfied and Company HK-F would not be denied deduction. Company HK-L in effect made use of the sale and license back arrangement to obtain cheaper finance for its business use. Company HK-F, the licensor, had in effect committed capital into the copyright, incurring genuine commercial risk. The whole arrangement is a normal commercial transaction.

62. Since entitlement to deduction is automatic upon purchase of the Relevant Rights, in order for the exception in paragraph 61 above to apply, it will be necessary for the end-user to submit a disclaimer to the Commissioner in writing within 3 months of the date on which the Relevant Right was acquired, or within such further period as the Commissioner may permit. Generally, the Department will not entertain requests for an extension of the 3-month disclaimer period. A notice of disclaimer should be accompanied by the following information –

- (a) a description of the Relevant Right;
- (b) the name and address of the seller (or preceding seller);

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- (c) the date of purchase from and price paid to the seller (or preceding seller);
- (d) the date of sale to and price paid by the licensor; and
- (e) the name and address of the licensor.

The above information must be supported by copies of the purchase and sale agreements or invoices and the licence agreements.

63. After submitting notice of a disclaimer, the end-user might decide to retain the right to claim deduction and seek to cancel the sale and license back arrangement. As a concession, the Department is prepared to allow the withdrawal of a disclaimer, provided that the relevant assessment has not yet become final and conclusive.

Used “wholly or principally” outside Hong Kong by persons other than the taxpayer

64. Section 16EC(4)(b) stipulates that no deduction is allowable under section 16E or 16EA in respect of any Relevant Right by a person if at any time when the Relevant Right is owned by that person, another person holds rights as a licensee under a licence of the Relevant Right, and the Relevant Right is, while the licence is in force, used wholly or principally outside Hong Kong by a person other than the person who owns the Relevant Right. Taking into consideration of the peculiar nature of IPRs, the territorial registration system and protection of the rights and the wide scope in which the rights can be used, the Department is prepared to adopt a pragmatic approach in applying the provisions. The application of section 16EC(4)(b) is illustrated by the following examples.

Example 13

Company HK, which carries on a trading business in Hong Kong, purchased a trade mark registered in Hong Kong at a cost of \$1,000,000 during the year of assessment 2011/12 (the company closes its accounts on 31 March). The trade mark has not been registered in places other than Hong Kong. Company HK contracted Company M, a manufacturer located in the Mainland to produce goods bearing the Hong Kong registered trade mark. The finished goods were sold by Company HK to customers

in Hong Kong and the profits derived are chargeable to tax in Hong Kong.

Company HK has only purchased the Hong Kong registered trade mark and has not acquired any right to use the trade mark in places other than Hong Kong. When manufacturing the goods in the Mainland, what Company M used is an unregistered trade mark in the Mainland, not the trade mark registered in Hong Kong. In the circumstances, section 16EC(4)(b) is not applicable. Since the profits derived by Company HK from selling the finished goods are chargeable to tax in Hong Kong and provided that other deduction requirements are satisfied, Company HK is entitled to deduct one-fifth of the purchase cost of the Hong Kong registered trade mark for the year of assessment 2011/12 in the amount of \$200,000 [i.e. \$1,000,000 ÷ 5].

Example 14

Company HK, which carries on a trading business in Hong Kong, purchased a trade mark registered in Hong Kong at a cost of \$2,000,000 during the year of assessment 2011/12 (the company closes its accounts on 31 March). The trade mark has not been registered in places other than Hong Kong. Company HK subsequently registered the same trade mark in the Mainland and contracted a Mainland manufacturer, Company M, to produce in the Mainland goods bearing the trade mark. The goods produced by Company M were sold in Hong Kong by Company HK and the profits derived are chargeable to tax in Hong Kong.

Company HK has only purchased the Hong Kong registered trade mark but not the Mainland registered trade mark. It becomes the registered owner of the Mainland registered trade mark because it has subsequently registered the trade mark in the Mainland. The trade mark used by Company M in the production of goods in the Mainland is the one registered in the Mainland by Company HK and not the Hong Kong registered trade mark purchased by Company HK. As such, section 16EC(4)(b) is not applicable. Since the profits derived by Company HK from selling the finished goods are chargeable to tax in Hong Kong and provided that the other deduction requirements are satisfied, it is entitled to deduct one-fifth of the purchase cost of the Hong Kong registered trade mark for the year of assessment 2011/12 in the amount of \$400,000 [i.e. \$2,000,000 ÷ 5].

Example 15

Company HK, carrying on a trading business in Hong Kong, has during the year of assessment 2011/12 (the company closes its accounts on 31 March) purchased a trade mark registered both in Hong Kong and the Mainland at a total cost of \$3,000,000. The Hong Kong registered trade mark and the Mainland registered trade mark were each valued at \$1,500,000. Company HK contracted Company M, a contract manufacturer located in the Mainland, to produce goods bearing the trade mark.

Scenario 1

All of the finished goods were sold by Company HK to customers in Hong Kong and the profits derived are chargeable to tax in Hong Kong.

Insofar as the trade mark registered in Hong Kong is concerned, it was used by the Company HK itself for selling the finished goods to produce profits chargeable to tax in Hong Kong. Section 16EC(4)(b) is therefore not applicable. In the year of assessment 2011/12, Company HK is entitled to deduct one-fifth of the purchase cost of the Hong Kong registered trade mark for the year of assessment 2011/12 in the amount of \$300,000 [i.e. $\$1,500,000 \div 5$].

As for the Mainland registered trade mark, it was used by Company M for production of goods in the Mainland. As such, section 16EC(4)(b) is applicable and the purchase price of \$1,500,000 for the Mainland registered trade mark is not deductible.

Scenario 2

The finished goods were sold by Company HK to customers in Hong Kong and the US. The profits so derived are chargeable to tax in Hong Kong.

Insofar as the trade mark registered in Hong Kong is concerned, it was used by Company HK itself for selling of the finished goods to produce profits chargeable to tax in Hong Kong. In addition, Company HK when selling the goods in the US market is not using the trade mark registered in Hong Kong. As such, section 16EC(4)(b) is not applicable. In the year of assessment 2011/12, Company HK is entitled to deduct one-fifth of the purchase cost of the Hong Kong registered trade mark for the year of

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assessment 2011/12 in the amount of \$300,000 [i.e. \$1,500,000 ÷ 5].

As for the Mainland registered trade mark, it was used by Company M for production of goods in the Mainland. As such, section 16EC(4)(b) is applicable and the purchase price of \$1,500,000 for the Mainland registered trade mark is not deductible.

Scenario 3

Company M manufactured 1,000,000 pieces of goods during the year of assessment 2011/12 and they were sold by Company HK to customers in Hong Kong, the US and the Mainland in the respective quantities of 200,000, 200,000 and 600,000. The profits so derived are all chargeable to tax in Hong Kong.

Insofar as the trade mark registered in Hong Kong is concerned, it was used by Company HK itself for selling of finished goods to produce profits chargeable to tax in Hong Kong. In addition, Company HK when selling the goods in the US market and the Mainland market is not using the trade mark registered in Hong Kong. As such, section 16EC(4)(b) is not applicable. In the year of assessment 2011/12, Company HK is entitled to deduct one-fifth of the purchase cost of the Hong Kong registered trade mark in the amount of \$300,000 [i.e. \$1,500,000 ÷ 5].

As for the Mainland registered trade mark, it was partly used by Company M for production of goods in the Mainland and partly used by Company HK for selling some of the finished goods in the Mainland. In the circumstances, section 16EC(4)(b) is applicable to the part of the Mainland registered trade mark that was used by Company M in the Mainland manufacturing activities. Nevertheless, Company HK is still entitled to deduct part of purchase price of the Mainland registered trade mark which was used by itself to sell the finished goods in the Mainland and has produced profits chargeable to tax in Hong Kong.

In calculating the deductible amount, one possible method of apportionment is the ratio of deductible activities (i.e. sales) to total activities (i.e. sales and manufacturing) in connection with the use of the trade mark. The amount of deduction for the Mainland registered trade mark is calculated as follows –

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$$\begin{aligned} & \text{Purchase price} & & \text{No. of units sold in the Mainland} \\ & \text{of the Mainland} \div 5 \times \frac{\text{No. of units manufactured and sold}}{\text{mark}} \\ & = \$1,500,000 \div 5 \times \frac{600,000}{1,600,000} \\ & = \underline{\underline{\$112,500}} \end{aligned}$$

Leveraged licensing arrangement

65. A leveraged licensing arrangement is typically one in which a partnership of companies acquires a Relevant Right which it licenses for a fixed term, say 10 years, to a licensee and where, by reason of the “leverage” obtained from the borrowing of a substantial non-recourse loan, the members of the partnership are effectively at risk for no more than a relatively small part of the funds used to acquire the Relevant Right. The lenders’ security for the substantial amounts lent to acquire the Relevant Right is limited to the Relevant Right itself and/or by way of a charge over the licence and the related licence fees or royalties.

66. So far as it relates to leveraged licensing arrangements, section 16EC(4)(c) denies deduction to a taxpayer (as licensor) where the whole or a predominant part of the cost of the Relevant Right was financed directly or indirectly by a non-recourse debt.

67. The term “non-recourse debt” is defined extensively in section 16EC(8) but in broad terms means, as mentioned above, a method of financing where the borrower has no absolute liability in respect of the borrowing and in the event of default in repayment the rights of the lender are restricted to the Relevant Right itself or the income generated by it.

EFFECTIVE DATES

Commencement of new sections 16EA, 16EB and 16EC

68. Sections 16EA and 16EB which are applicable to the Specified IPRs (i.e. copyrights, registered designs and registered trade marks) and section 16EC which is applicable to the Relevant Rights (i.e. patent rights, rights to know-how, copyrights, registered designs and registered trade marks) will apply from the year of assessment commencing on 1 April 2011.

Amendments to section 16E

69. The amended section 16E(3) and the added definition in section 16E(4) of the “relevant proceeds of sale” in relation to the sale of patent rights or rights to know-how do not apply if –

- (a) a deduction has previously been allowed under section 16E(1) in respect of the rights; and
- (b) the rights are sold by the person during the basis period for any year of assessment preceding the year of assessment beginning on 1 April 2011 or are sold under a contract entered into during such a basis period.

70. The following amended or new provisions under section 16E relating to patent rights and rights to know-how will apply from the year of assessment commencing on 1 April 2011 –

<u>Section</u>	<u>Amendment made</u>
16E(1)	To remove the “use in Hong Kong” condition.
16E(1A)	To explicitly provide that the qualifying expenditure includes legal expenses and valuation fees incurred in connection with the purchase of patent rights and rights to know-how.
16E(2)	To allow deduction to the extent of the use of the patent rights and rights to know-how in the production of chargeable profits.

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- 16E(3A) To deem pre-commencement expenditure on the patent rights and rights to know-how to be incurred on the first day the trade, profession or business commences.
- 16E(7) To empower the Commissioner to allocate consideration where the patent rights and rights to know-how are purchased or sold together or with any other assets for one consideration.
- 16E(8) To empower the Commissioner to determine the true market value of the patent rights and rights to know-how.
- 16E(9) To put beyond doubt that expenditure incurred on the acquisition of a licence of the patent rights and rights to know-how is not deductible.

PART B : TAXATION OF ROYALTIES DERIVED FROM LICENSING OF INTELLECTUAL PROPERTY RIGHTS

THE “SOURCE” PRINCIPLE

71. Hong Kong adopts the “territorial source principle” in charging profits tax. That is, profits arising in or derived from Hong Kong are assessable to tax whilst profits arising in a territory outside Hong Kong are not taxable. In determining the source of profits, the broad guiding principle is that *“one looks to see what the taxpayer has done to earn the profits in question and where he has done it”*. The Department’s views on the locality of profits are set out in detail in Departmental Interpretation and Practice Notes No. 21. This fundamental territorial source principle is also applicable in determining the source of royalty income. Having said that, it should be noted that section 15(1)(a), (b) and (ba) has been enacted to deem certain receipts, not otherwise taxable, chargeable to Hong Kong tax and to prescribe the percentage to be taken as assessable profits. In broad terms, they cover royalties and licence fees for the use of or right to use in Hong Kong certain industrial and intellectual properties. The Department’s views and practice relating to section 15(1)(a), (b) and (ba) are contained in Departmental Interpretation and Practice Notes No. 22.

APPLICATION OF THE “SOURCE” PRINCIPLE

72. Whether royalties derived from licensing activities are chargeable to tax in Hong Kong depends on the facts of each case. No single test is decisive. The Department’s views regarding the source of royalty income are set out in the following paragraphs.

Where the IPR is created or developed by the licensor

73. If an IPR is created or developed by a taxpayer carrying on business in Hong Kong 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 section 16B if such expenses are related to R&D.

Where the IPR is purchased by the licensor

74. 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 and if the IPR is a Relevant Right, no deduction will be allowed for the capital expenditure incurred on acquiring the Relevant Right.

Where the IPR is not owned by the licensor

75. If a taxpayer only obtains 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-licenses the IPR to another party for use outside Hong Kong, the Department will, in ascertaining whether the royalties so derived are Hong Kong sourced income, take the place of acquiring and granting the licence as the source of income. As such, if the taxpayer acquires in Hong Kong the licence for use of the IPR, and grants a sub-licence also in Hong Kong, the royalties derived from sub-licensing the IPR will be regarded as derived from Hong Kong. As the taxpayer has not acquired the proprietary interest of the IPR which is a Relevant Right, he is not eligible to obtain the deduction for the capital expenditure incurred on the Relevant Right. The licence fee incurred by the taxpayer will be deductible if it satisfies the conditions provided under the general deduction provisions of section 16(1).

76. The above are some general examples which illustrate the Department's views on the application of broad guiding principle. It must be emphasised that whether royalties derived from the licensing of IPRs by taxpayers carrying on business in Hong Kong are subject to tax will be a question of fact to be determined by the totality of the facts and circumstances in each case.