Bills Committee on Inland Revenue (Amendment) Bill 2000

Administration's Response to Issues raised at the Meeting on 5 February 2004

Purpose

This paper sets out the follow-up actions taken by the Administration on issues raised by Members at the meeting of the Bills Committee on Inland Revenue (Amendment) Bill 2000 on 5 February 2004.

Clause 4 – Adjustments to assessable income

2. Under the existing section 12(6) of the Inland Revenue Ordinance (IRO) as well as under the amended provisions proposed by the Administration, only expenses paid by a taxpayer on a course of education "provided" by a specified education provider or a training or development course "provided" by a trade, professional or business association that is undertaken to give or maintain qualifications for use in any employment are eligible for salaries tax deduction.

3. At the meeting on 5 February 2004, a number of Members expressed that as some professional associations seldom provide courses themselves but may recognise or accredit courses provided by other course providers, the existing section 12(6) was too limited. They requested the Administration to review and expand the scope of education courses for salaries tax deduction. A Member suggested that the scope of education courses should be extended to cover the "statutory professional bodies" under their respective continuous professional development programmes (CDPs). Another Member suggested that the Administration could consider extending the scope to cover certain or all courses accredited or recognised by all professional bodies. A Member expressed that the training courses, such as those for security and guarding personnel, recognised by the Vocational Training Council (VTC) should also be covered in the tax deduction. We understand that this refers to the entrustment of the Security and Guarding Services Industry Authority (SGSIA), a statutory body formed under the Securities and

Guarding Services Ordinance (Cap. 460), to VTC to take over its recognition scheme.

4. In view of Members' request, the Administration has reviewed 22 ordinances which concern the registration and recognition of professional or occupational qualifications or status, or the granting of permits or licences for practising in the professions, trades or occupations. It is noted that while these ordinances may have established some organisations for the purpose of registration and recognition of professional qualifications or status, or for the purpose of granting permits or licences for practising in a profession, trade or occupation, these "statutory organisations" may not necessarily be the professional associations that have a role in setting the standard of qualification in the profession (e.g. while the court is the authority for admitting solicitors under the Legal Practitioners Ordinance (Cap. 159), the Law Society of Hong Kong is the professional association which sets the standards of qualification of solicitors). On the other hand, some professional associations, though referred to in the relevant ordinances, are not "statutory organisations" as they are not established under the ordinances. These include the Law Society of Hong Kong, which, according to their web-site, was incorporated in 1907 as a company limited by guarantee. Thus the suggestion of expanding the scope to cover courses recognised or accredited by "statutory professional bodies" may not be able to cover the major professional associations envisaged by Members.

5. We are considering whether it would be possible to expand the scope to cover organisations that are mentioned or referred to in the 22 ordinances that have a role in recognising the professional qualifications of people in the industry (i.e. not only the statutory bodies established under the ordinances). In order to know the course accreditation and recognition policies of these organisations, and to ensure that there will be no omission of major professional organisations, we are in the process of consulting the relevant Bureaux and Departments. We will revert to Members when ready.

Clause 5 – Certain amounts deemed trading receipts

Possible Impacts of the proposed clause

6. Members asked the Administration to assess the possible impact of the proposed clause and to provide information on the tax rates on royalty income in other tax jurisdictions for comparison.

7. The Administration would like to point out that since section 15(1)(b) was first introduced in 1971, it had all along been the practice of the Inland Revenue Department to tax royalty payments which are tax deductible in the accounts of the payer. This practice was only changed by the decision on the Emerson case by the Court of Final Appeal in December 1999. The addition of section 15(1)(ba) currently proposed is only meant to reverse the tax treatment to the position before the Emerson case. Therefore, the proposed section is not an introduction of a new tax measure. The question of the "change" causing significant impact on investments in Hong Kong should therefore not arise.

8. In Hong Kong, as from the 2003/04 year of assessment, generally only 30% of the royalty income payable to a non-resident person is chargeable to tax. At the existing corporate profits tax rate of 17.5%, the effective tax rate on royalty income is only 5.25% (30% x 17.5%). As illustrated in the table below, this tax rate is highly competitive among other jurisdictions.

Jurisdiction	**Effective withholding tax rate on royalty payments to non-resident company**
Australia	30% (lower rate for treaties countries)
The UK	22%
Japan	20%
Indonesia	20%
New Zealand	15% (lower rate for treaties countries)
Singapore	15% (22% if the royalty income is derived from a trade carried on in Singapore)
Thailand	15% (Final withholding tax on non-residents not carrying on business in Thailand)
Malaysia	10%
China	10%
Hong Kong SAR	**5.25%**

Examples of Royalty Income chargeable under section 15(1)(ba)

9. Members have asked for examples to illustrate the royalty income that is not chargeable to profits tax under the existing section 15(1)(b) but would be chargeable under the proposed section 15(1)(ba). The most typical example is the royalty payment in the Emerson case. It was ruled by the Court of Final Appeal in that case that only when the trade mark is physically applied in Hong Kong to goods manufactured here, there would be use of the trade mark in Hong Kong. It also ruled when the trade mark was applied to goods that were manufactured outside Hong Kong, the mark was used outside Hong Kong, even though the taxpayer carried on business in Hong Kong, paid the royalty in the course of running his business here, and claimed a tax deduction in respect of the royalty payment paid. The court further ruled that royalty payments relating to goods manufactured outside Hong Kong are not chargeable to tax under section 15(1)(b).

10. In arriving at the above ruling, it seems that the court was assuming that when the goods are manufactured in one place, trade marks will be applied in the same place. Carried to its extreme, this interpretation will render royalty payments not subject to tax in Hong Kong even if the goods are manufactured here, so long as the process of applying the trade mark to the goods or the packaging is done outside Hong Kong. Tax avoidance can be easily achieved by changing the manufacturing process.

11. The proposed section 15(1)(ba) seeks to bring such royalty incomes back into the tax net. We estimate that annually $200 million is at stake.

The Implication of the Enactment of the new Trade Marks Ordinance (Cap. 559)

12. The Legislative Council Assistant Legal Adviser asked the Administration to clarify the implication on our proposed Bill of the new Trade Marks Ordinance (Cap. 559) which was enacted in April 2003 and the repealing of the old Trade Marks Ordinance (Cap. 43). In particular she noted that section 39 of the old Ordinance (which deemed the

application in Hong Kong of a trade mark to goods to be exported from Hong Kong as constituting use of that mark in Hong Kong) on which the Court in the Emerson case relied in arriving at its decision was not reproduced in the new Ordinance.

13. The Administration considers that the enactment of the new Trade Marks Ordinance in April 2003 does not change the need for the proposed amendment to the Inland Revenue Ordinance. Firstly, section 39 of the old Trade Marks Ordinance was effectively reproduced in section 52(3)(b) and (c) of the new Trade Marks Ordinance. Insofar as the application of a trade mark to goods is concerned, the effect of the old and new provisions is the same, i.e. if a trade mark is applied to goods in Hong Kong solely for export purposes, it is deemed to be used in Hong Kong.

14. Secondly, in the Emerson case, Lord Hoffman NPJ of the Court of Final Appeal referred to section 39 of the then Trade Marks Ordinance and decided that the application of the trade mark in Hong Kong to goods to be exported from Hong Kong constituted use of the trade mark in Hong Kong (Lines F to G on page 506 on the Extract of the Case). However, the Emerson case also decided that if a trade mark was applied to goods *outside* Hong Kong, it was *not* used in Hong Kong. In making the decision in this regard, Lord Hoffman did not make reference to section 39. Indeed section 39 only deemed the application of a trade mark in Hong Kong to goods to be exported as constituting use of the mark in Hong Kong, but did not deal with the situation where a trade mark was applied to goods elsewhere. His Lordship simply relied on the principle of territoriality of each mark – "in authorizing the use of mark in Thailand, Emerson HK was using the Thai mark and the only place where the Thai mark could be used was Thailand" (see lines I to J in page 508). This principle will not be changed by the enactment of the new Trade Marks Ordinance. The Administration therefore considers that the court's decision in the Emerson case would be the same before or after the amendment of the Trade Marks Ordinance, insofar as the trade mark is applied to goods outside Hong Kong. Accordingly, it is still necessary to set out the "deductibility test" in the IRO.

Provisions that involve "departure" from the Territorial Source Principle

15. Members enquired whether there are provisions in the existing provisions of the IRO which involve "departure" from the territorial source principle, and if so whether these departures are based on the principle of maintaining tax "symmetry".

16. Certain provisions in the IRO deem certain income/profit chargeable to tax. These provisions were introduced mainly with a view to combating anti-avoidance, with some by clarifying areas where the source of an income might not be easily ascertained.

17. An example of provisions introduced to clarify where the source of an income might not be easily ascertained is section 15(1)(c). Under this section, sums received by a person by way of grant or subsidy in connection with the carrying on of a business in Hong Kong is deemed to be taxable income, even though the sums may be contributed by the company's overseas parent company and may thus be argued as sourced outside Hong Kong. Another example is the taxing of interest and profits from debt instruments made by financial institutions carrying on business in Hong Kong. Section 15(1)(i) and (l) deem the interest from loans and profits from debt instruments respectively accrued to a financial institution which arise through or from the carrying on of its business in Hong Kong to be taxable income, notwithstanding that the provision of credit in respect of the loans (the usual test of source for interest) was, or the purchase cost of the debt instruments was provided, or the sale or redemption of such instruments (both bear on the "source test" for profits) was effected outside Hong Kong. These provisions were introduced as an anti-avoidance tool to counteract arrangements of offshore lending by financial institutions. The rationale for the amendment was that as far as banks (or financial institutions) are concerned, it is a bank's organisation in Hong Kong, and the use to which that organisation puts the raised funds by on-lending them, which are the source of its profits from interest. The amendment was introduced to clarify and uphold this interpretation of the source of interest for the financial industry. Tax "symmetry" (in terms of matching deductibility with taxability) was not explicitly considered when introducing the provisions, but, in effect, such was maintained by the amendment, since after the amendment a bank which can claim deduction of the interest it pays on the money it borrows in

Hong Kong will be taxed on the interest it earns from its lending of the money overseas.

18. An example of provisions which aim at taxing non-Hong Kong income for special reasons is section 23C(2A), (2B), (2C) and (2D). This section has the effect that where an arrangement for double tax relief is in place between Hong Kong and another territory, all the revenue accrued to a Hong Kong resident aircraft owner from the carriages shipped in the arrangement territory will be chargeable to tax in Hong Kong, provided that that revenue is not chargeable to tax in the that territory. This provision departs from the general principle that income arising from carriages shipped in a place is chargeable to tax in that place. These provisions were introduced to avoid the cases of "double non-taxation", where a taxpayer will not be taxed in both Hong Kong and the arrangement territory. The "symmetry" principle mentioned above is not the main consideration here.

Financial Services and the Treasury Bureau and
Inland Revenue Department
February 2004