

立法會
Legislative Council

LC Paper No. CB(1)2742/10-11
(These minutes have been seen
by the Administration)

Ref : CB1/BC/4/10/2

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

Third meeting on
Thursday, 2 June 2011, at 2:30 pm
in Conference Room B of the Legislative Council Building

Members present : Hon Paul CHAN Mo-po, MH, JP (Chairman)
Hon James TO Kun-sun
Hon CHAN Kam-lam, SBS, JP
Hon Miriam LAU Kin-ye, GBS, JP
Hon Abraham SHEK Lai-him, SBS, JP
Hon Audrey EU Yuet-mee, SC, JP
Hon WONG Ting-kwong, BBS, JP

Members absent : Ir Dr Hon Raymond HO Chung-tai, SBS, S.B.St.J., JP
Hon Mrs Regina IP LAU Suk-ye, GBS, JP

Public officers : Miss Cathy CHU
Attending Deputy Secretary for Financial Services and the
Treasury (Treasury)

Ms Shirley KWAN
Principal Assistant Secretary for Financial Services and
the Treasury (Treasury) (Revenue)

Miss Fiona CHAU
Assistant Secretary for Financial Services and the
Treasury (Treasury) (Revenue)

Mr WONG Kuen-fai
Deputy Commissioner of Inland Revenue (Technical)

Mr Tony WONG
Senior Assessor
Inland Revenue Department

Miss Betty CHEUNG
Senior Assistant Law Draftsman
Department of Justice

Mr Manuel NG
Government Counsel
Department of Justice

Clerk in attendance : Ms Anita SIT
Chief Council Secretary (1)5

Staff in attendance : Ms Wendy KAN
Assistant Legal Adviser 6

Mr Hugo CHIU
Council Secretary (1)5

I Meeting with the Administration

Follow-up to issues raised at meeting on 21 April 2011

(LC Paper No. CB(1)2356/10-11(01) — Administration's response to issues raised at the meeting on 21 April 2011

LC Paper No. CB(1)2368/10-11(01) — Administration's letter dated 1 June 2011 on the first batch of the Administration's response to submissions from deputations)

Other relevant papers

(LC Paper No. CB(3)517/10-11 — The Bill

LC Paper No. CB(1)1988/10-11(01) — Marked-up copy of the Bill prepared by the Legal Service Division

File Ref: TsyB R 183/535-1/8/0 — The Legislative Council Brief (10-11) (C) issued by the Financial Services and the Treasury Bureau

LC Paper No. LS37/10-11 — The Legal Service Division Report on Inland Revenue (Amendment) (No. 2) Bill 2011

LC Paper No. LS42/10-11 — The Legal Service Division further Report on Inland Revenue (Amendment) (No. 2) Bill 2011

Discussion

The Committee deliberated (Index of proceedings attached at **Appendix**).

Admin

Follow-up actions to be taken by the Administration

2. The Administration was requested to take the following follow-up actions:

- (a) to consider amending section 15(1) (ba) of the Inland Revenue Ordinance (Cap. 112) (IRO) to the effect that upfront payment for the licencing of a specified IPR, which was not deductible under the existing IRO and the Bill because it was regarded as "capital in nature", could be deductible and yet "tax symmetry" could be maintained;

(Post-meeting note: The Administration provided information on LC Paper No. CB(1)2356/10-11(01) and LC Paper No. CB(1)2437/10-11(01). The Administration also reiterated its stance on the issue at the 4th meeting of Bills Committee on Inland Revenue (Amendment) (No.2) Bill 2011 held on 14 June 2011.)

- (b) to advise whether the purchase of a specified IPR was considered as an outright purchase if the person who sold the IPR had an option to buy back the IPR; and

(Post-meeting note: The Administration gave its advice at the 4th meeting of Bills Committee on Inland Revenue (Amendment) (No.2) Bill 2011 held on 14 June 2011.)

- (c) to explain in the Departmental Interpretation and Practice Notes the arrangements regarding (i) tax deduction on the purchase of IPRs the registration of which were still being processed; and (ii) the clawback of tax deduction as previously allowed for invalidated IPRs.

(Post-meeting note: The Administration agreed to set out the arrangements in the Departmental Interpretation and Practice Notes to be issued by the Inland Revenue Department in due course.)

II Any other business

Date of next meeting

3. The Chairman informed members that the next meeting would be held on 14 June 2011, at 10:45 am.
4. There being no other business, the meeting ended at 4:10 pm.

Council Business Division 1
Legislative Council Secretariat
15 July 2011

**Proceedings of the
Bills Committee on Inland Revenue (Amendment) (No. 2) Bill 2011
Third meeting on Thursday, 2 June 2011, at 2:30 pm
in Conference Room B of the Legislative Council Building**

Time Marker	Speaker	Subject(s)	Action Required
000533 – 000711	Chairman	Introductory remarks	
000712 – 001050	Administration Chairman	<p><u>Legislative timetable</u></p> <p>At the invitation of the Chairman, the Administration advised that the Profits Tax Returns for the year of assessment 2011/12 had to be revised upon enactment of the Bill, and the revised forms were subject to the approval of the Board of Inland Revenue. Taking into account the time required for making the necessary preparation, the Administration would wish that the entire legislative exercise could be completed by early November 2011 the latest, so that the proposals in the Bill could be implemented for the year of assessment 2011/12 and onwards. Based on this time frame, the Bills Committee would need to complete the scrutiny of the Bill and report its deliberations to the House Committee by mid-October 2011.</p>	
001051 – 002523	Administration	Briefing by the Administration on paragraphs 2-12 of the paper entitled "Administration's response to issues raised at the meeting on 21 April 2011" (LC Paper No. CB(1)2356/10-11(01)) (1 st Paper)	
002524 – 003723	Chairman Administration	Noting from the 1 st Paper that tax deduction proposed in the Bill would not be extended to a lump-sum licensing fee (or upfront licence fee) which was capital in nature as it was necessary to maintain "tax symmetry" to avoid revenue loss, the Chairman enquired whether the same taxation arrangement for depreciation of fixed assets could be applied to the upfront fee paid for a licence to use a specified intellectual property right (IPR) so that the upfront fee would be subject to tax deduction. From the point of view of a company, both depreciation of fixed assets and the aforesaid upfront fee were cost incurred in conducting the business. The Government would not suffer revenue loss if the claw-back arrangement for depreciation (i.e. if a	

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		<p>company sold an asset at a price higher than the amount discounted by depreciation, the Government would claw back part of tax deduction previously granted in accordance with the relevant provisions in the Inland Revenue Ordinance (Cap. 112) (IRO)) was also applied to the upfront payment.</p> <p>The Administration explained that depreciation and upfront payment of a licence were different in nature. In the former case, the company possessed the ownership of the fixed assets. In the latter case, the company did not possess the ownership of the specified IPR. As upfront licence fees were capital in nature, and since Hong Kong did not tax the corresponding capital receipts of licensors, (for both local and overseas), Hong Kong would suffer revenue loss if tax deduction was extended to cover upfront licence fees. The Government needed to maintain the tax symmetry principle to avoid revenue loss. Other jurisdictions also followed the same principle in their taxation arrangements.</p>	
003724 – 005132	Mr James TO Administration Chairman	<p>Mr TO enquired whether a taxpayer having partial ownership of a specified IPR could apply for tax deduction. The Administration explained that such taxpayer could also apply for tax deduction as long as the taxpayer had a share of the legal and economic ownership of the IPR, and the taxpayer might claim tax deduction based on the amount he paid for his share of ownership of the IPR.</p> <p>Mr TO asked if company X acquired the majority of shares in company Y, whether company X could enjoy tax deduction for using a specified IPR owned by company Y.</p> <p>The Administration clarified that the acquisition of shares in a company was not equivalent to the acquisition of a company's assets. Company Y being the owner of a specified IPR could apply for tax deduction for capital expenditure incurred in the purchase of the specified IPR if the IPR was used for production of chargeable profits.</p>	

Time Marker	Speaker	Subject(s)	Action Required
		<p>Mr TO asked if company Y granted the use of the specified IPR to company X at a fee, whether company X would be able to enjoy tax deduction, given company X was company Y's associate. The Administration advised that under the existing IRO, if company Y licensed the use of an IPR to company X at a fee, the licensing fee received by company Y was subject to tax while the licensing fee paid by company X was tax deductible, provided that the licensing fee was revenue in nature.</p> <p>The Chairman enquired about the detailed taxation arrangements on royalties if the parties to a licence agreement were associates. The Administration explained the relevant arrangements provided under the existing IRO.</p>	
005133 – 005415	Chairman Mr James TO Administration	<p>Mr TO queried the basis for treating the upfront fee as a capital expenditure for taxation purpose. The Administration explained that such interpretation was based on case law. According to case law, expenditure would be capital in nature for taxation purpose if the expenditure as incurred was to secure benefits for a business that were enduring in nature.</p>	
005416 – 010235	Chairman Administration	<p>The Chairman noted that given that the term "sums" was used in section 15(1)(ba) of IRO, he was of the view the above section could apply to fee in relation to the use of IPR under a licence i.e. subject to withholding tax regardless of whether it was capital or revenue in nature.</p> <p>The Administration responded that although a general term "sums" was used in section 15(1)(ba), which deemed certain receipts received by or accrued to a person (usually a non-resident who did not carry on business in Hong Kong) as trading receipts and chargeable to profits tax, an upfront licence fee, which was capital in nature, should not be chargeable to tax under section 15(1)(ba). Reference should also be made to section 14(1) of IRO which expressly provided that profits arising from the sale of capital assets were not subject to profits tax. The Administration reiterated that Hong Kong did not tax capital receipts.</p>	

Time Marker	Speaker	Subject(s)	Action Required
		<p>The Chairman suggested, having regard to the actual business environment of Hong Kong and to achieve the policy objective of the Bill, it was worthwhile to consider amending section 15(1)(ba) of IRO to capture the upfront payment for the licencing of a specified IPR, which was not taxable because it was regarded as "capital in nature".</p> <p>The Administration remarked that Hong Kong's tax principle of not taxing capital receipts would be altered if section 15(1)(ba) was revised according to the Chairman's suggestion. The Administration reiterated that a basic feature of Hong Kong's taxation regime was that capital expenditure was not tax deductible unless special arrangement was provided in the legislation. By symmetry, capital receipts were not taxable either. Providing tax deduction for the upfront payment for the licencing of a specified IPR, which was capital in nature, would result in revenue loss as Hong Kong did not impose tax on the corresponding capital receipts.</p>	
010236 – 011547	Mr James TO Chairman Administration	<p>In response to Mr TO's enquiry, the Administration confirmed that the payment method (such as by way of a lump sum payment or by instalments) was not a conclusive factor in determining whether an expenditure for the purchase of a specified IPR was tax deductible, while acquisition of the legal ownership of the specified IPR concerned was the determining factor.</p> <p>Pointing out that some IPRs like trade mark had limited protection life, Mr TO cited a situation that company X purchased the ownership of a trade mark with 5 years of life protection left, whereas company Y acquired a license to use for 17 years a trade mark having 18 years of protection life left. Company X would enjoy tax deduction but company Y would not. Mr TO commented that such situation was absurd.</p> <p>Mr TO requested the Administration to advise whether the purchase of a specified IPR was considered as an outright purchase if the person who sold the IPR had an option to buy back the IPR.</p>	The Administration to take action as per paragraph 2 of the minutes.

Time Marker	Speaker	Subject(s)	Action Required
		<p>The Chairman noted from the long title of the Bill that the object of the Bill was to provide tax deduction for capital expenditure incurred on the purchase of the specified IPRs.</p> <p>The Administration clarified that the long title of the Bill had explicitly specified that only capital expenditure incurred on the purchase of a specified IPR would be tax deductible, and reiterated that the Government needed to uphold the tax symmetry principle. The Administration also referred to the proposed new section 16E(9) which explicitly provided that <i>"To avoid doubt, any expenditure incurred on the acquisition of a licence (as defined by section 16EC(8)) of any rights of a kind referred to in subsection (1) is not deductible under that subsection."</i></p> <p>The Chairman remarked that members and the Administration had stated their views on the issue and members might have to move Committee Stage amendments if the views of the two sides could not be reconciled. The Chairman suggested the Administration study the views expressed by members and the Bills Committee would further discuss the issue in the next meeting.</p>	<p>The Administration to take action as per paragraph 2 of the minutes.</p>
011548 – 011943	Administration	<p>Briefing by the Administration on paragraphs 13-15 of the 1st Paper. Regarding the Mainland's position on the issue of transfer pricing, the Chairman sought clarification that for an arrangement to be regarded as an "offsetting transaction", two elements should be present, i.e. (i) a Hong Kong enterprise provided its associated enterprise in the Mainland with the use of an IPR owned by the Hong Kong enterprise on a rent-free basis for production of finished products; and (ii) the goods would be sold to the Hong Kong enterprise at a price below normal price. The Administration replied in the affirmative.</p>	
011944 – 012834	Administration	<p>Briefing by the Administration on items 1 to 3 of its first batch of response to submissions from deputations (LC Paper No. CB(1)2368/10-11(01)) (2nd Paper)</p>	

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		<p>Noting from the Administration's response in the paper that "Cost incurred in developing IPs under a cost-sharing arrangement is not deductible under the said provision [existing section 16B of the IRO] as such arrangement is prone to tax abuse", the Chairman asked for examples of tax avoidance through the cost-sharing arrangement which could not be guarded against by the existing anti-avoidance provisions.</p> <p>The Administration replied with the following example: a company in Hong Kong signed a contract with an overseas company to conduct research and development of a product. However, the agreement was highly unfavourable to the company in Hong Kong in that the company in Hong Kong paid for most of the expenditure but the ownership of the product was possessed by the overseas company. The Administration remarked that in invoking the anti-avoidance provisions, the Administration had to prove the intent of tax avoidance of the parties concerned. It was very difficult to obtain such proof if the parties concerned colluded for tax avoidance. The Administration added that the Model Tax Convention of the Organization for Economic Co-operation and Development had a chapter on cost-contribution agreement to address this issue.</p>	
012835 – 013021	Chairman Administration	Briefing by the Administration on items 4 and 5 of the 2 nd Paper.	
013022 – 013402	Administration Chairman	<p>Briefing by the Administration on items 6 and 7 of the 2nd Paper.</p> <p>The Chairman requested the Administration to explain in the Departmental Interpretation and Practice Notes the arrangements regarding (i) tax deduction on the purchase of IPRs the registration of which were still being processed; and (ii) the clawback of tax deduction as previously allowed for invalidated IPRs. The Administration agreed.</p>	The Administration to take action as per paragraph 2 of the minutes
013403 – 013647	Administration	Briefing by the Administration on items 8 and 9 of the 2 nd Paper.	

Time Marker	Speaker	Subject(s)	Action Required
013648 – 013909	Chairman	The Chairman remarked that since the Council meeting of 15 June 2011 would likely continue in the morning of the next day, the Bills Committee would hold the next meeting on 14 June 2011 at 10:45 am instead of on 16 June 2011 at 10:45 am.	

Council Business Division 1
Legislative Council Secretariat
15 July 2011