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Hon Paul CHAN Mo-po, MH, JP
Chairman
Bills Committee on Inland Revenue (Amendment) (No. 2) Bill 2011
Legislative Council
Hong Kong SAR Government

20 May 2011

Dear Hon Paul Chan,

Submission on the Inland Revenue (Amendment) (No. 2) Bill 2011

We refer to your invitation for submission on the Inland Revenue (Amendment) (No. 2) Bill 2011 ("Bill") and set out below our comments on the Bill for your consideration.

Practical issues arising from the proposed Section 16EC(4)(b)

As stated in the Legislative Council Brief on the Bill, the justifications of the Bill are "*to promote the wider application of intellectual property rights by enterprises, to encourage innovation and upgrading and to facilitate development of creative industries in Hong Kong*". Given this legislative intent, it is doubtful whether the current draft legislation would be able to serve its intended purpose. This is particularly true given the unclear sourcing rule for royalties / licensing fees under the current guidance and assessing practice of the Inland Revenue Department ("IRD"). This is further illustrated by the situations and examples discussed below.

1. Licensing of specified intellectual property rights ("specified IPRs") for use outside Hong Kong

   Example 1:

   A Hong Kong company is engaged in the business of acquiring specified IPRs from different unrelated sources, carrying out further improvement / enhancement work on the specified IPRs in Hong Kong and then licensing them to overseas customers for use outside Hong Kong in return of a license fee.

   Under such situation, deduction of the purchase cost of the specified IPRs incurred by the Hong Kong company will be denied pursuant to the proposed section 16EC(4)(b), as the specified IPRs are used wholly or principally outside Hong Kong by someone else under a licence. On the other hand, it is currently unclear whether the license fees received by the Hong Kong company will be subject to Hong Kong profits tax based on our understanding of the current practice of the IRD in determining the source of royalty income. Revised Departmental Interpretation & Practice Notes No. 21 issued in December 2009 only spells out the IRD's view on the sourcing rule for royalties arising from a "license and sub-license" arrangement, but not an "acquisition and license" arrangement. If the IRD treats the licensing fees in this case as having a Hong Kong source (say following the *Lam Soon Trademark Ltd v CIR* case), the Hong Kong company will be in an awkward position whereby the costs of the specified IPRs are not deductible whereas the licensing fees are taxable for Hong Kong profits tax purposes.

The uncertainty and potential absurdity mentioned above will certainly discourage Hong Kong companies from holding and exploiting intellectual property ("IP") in Hong Kong and create an obstacle for developing Hong Kong as an IP hub.

Example 2:

Similarly, a Hong Kong company engaged in garment trading may purchase a registered trademark or design from an overseas unrelated company, carry out further improvement / enhancement work on the trademark / design in Hong Kong (to make use of the skilled labor, advanced technology and protection of IP rights in Hong Kong) and then license the trademark or design to a manufacturing subsidiary in China (to take advantage of the low production cost in China) for production of garments. The Hong Kong company will receive royalty income from the subsidiary for the use of the trademark / design in China and purchase the finished goods from the subsidiary at an arm's length price for resale to its customers.

Similar to Example 1 above, deduction of the purchase cost of the trademark /design incurred by the Hong Kong company will be denied under the proposed section 16EC(4)(b), as the trademark / design is used wholly or principally outside Hong Kong by the subsidiary in China under a licensing arrangement. On the other side, it is unclear whether the royalty income received by the Hong Kong company from the subsidiary will be subject to Hong Kong profits tax.

This would again affect the normal business activities of Hong Kong companies and create an unintended result similar to that of applying section 39E of the Inland Revenue Ordinance to Hong Kong companies engaged in cross-border processing trade business.

2. Use of specified IPR outside Hong Kong under contract/import processing

Referring to the definition of "licence" in the Bill, we would like to seek a clarification from the Administration on whether provision of a specified IPR by a Hong Kong taxpayer to an overseas manufacturing entity (free of charge) for use in the production of goods for the Hong Kong taxpayer under a contract processing or an import processing arrangement will be regarded as a "licence" for the purpose of section 16EC(4)(b).

If the answer is yes and on the assumption that the proposed section 16EC(4)(b) would not be revised or removed, we are of the view that the definition of licence should be revised to specifically exclude these kinds of arrangement from the definition in order not to affect the normal business activities of Hong Kong companies engaged in cross-border processing trade.

Under the current practice of the IRD, 50% of the depreciation allowance on the plant and machinery used outside Hong Kong under a contract processing arrangement is granted to the Hong Kong taxpayer as a concession. In view of this current practice, we would also like to seek a clarification from the Administration on whether similar concession will be granted to Hong Kong taxpayers for deducting 50% of the cost of the specified IPR under a similar contract processing arrangement should the current draft legislation remain unchanged.

In view of the above, we are of the view that the provisions in the proposed section 16EC(4)(b) should either be revisited/removed. In fact, we could not see the necessity of including the proposed section 16EC(4)(b) as any specified capital expenditure not incurred in the production of assessable profits would have already been denied under the proposed section 16EA(2) and the IRD can also apply the general anti-avoidance provisions in section 61 or 61A to any arrangement involving tax avoidance.

In addition, the sourcing rule for royalties/licensing fees should be further clarified. In particular, the IRD should clarify the rule for determining the source of royalties arising from licensing an acquired or self-developed IP and whether apportionment is possible say, for example, when the acquisition is effected / development is done in Hong Kong whereas the licensing is effected outside Hong Kong.

Denial of deduction for purchase from associate

While we appreciate the necessity for the Administration to include anti-avoidance provisions in respect of purchase of specified IPRs from an associated party in the draft legislation, the current broad-brush approach of denying deduction in respect of *any* specified IPR purchased wholly or partly from an associate as proposed in section 16EC(2) would again unintentionally affect certain normal merger and acquisition transactions.

For example, a Hong Kong company would like to acquire a company (the target) which holds numerous specified IPRs registered in various jurisdictions and transfer the ownership of these specified IPRs to itself for a commercial or legal reason. Due to the complicated and lengthy legal procedures of transferring the ownerships of such specified IPRs in various jurisdictions, it is often difficult in practice for the Hong Kong company to finish the transfer of all the specified IPRs within a reasonable short period of time before the acquisition. In order to avoid any delay in the acquisition process, the Hong Kong company will instead purchase these specified IPRs from the target after the acquisition and by that time, the target has already become an associate of the Hong Kong company. In such case, the costs of acquiring the specified IPRs incurred by the Hong Kong company will be denied for deduction under the proposed section 16EC(2). As such, we suggest that the Administration consider putting an escape clause in the section such that normal merger & acquisition activities will not be affected inadvertently.

If you have any questions on our submission, please feel free to contact me at peter.sh.yu@hk.pwc.com or Mr Fergus Wong, our technical director, at fergus.wt.wong@hk.pwc.com

Yours sincerely,
For and on behalf of PricewaterhouseCoopers Limited

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