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31 May 2011

Ms Anita SIT
Clerk to Bills Committee
Legislative Council Secretariat
Legislative Council Building
8 Jackson Road, Central
Hong Kong
(Fax: 2121 0420)

Dear Ms SIT,

Inland Revenue (Amendment) (No. 2) Bill 2011

Further to the discussions at the meeting of the Bills Committee on the Inland Revenue (Amendment) (No. 2) Bill 2011 ("the Bill") on 21 April 2011, we are pleased to provide below the relevant information in response to Members' requests.

To provide information on the taxation relief arrangements in respect of trading of intellectual property rights (IPRs) under the model double taxation relief agreement of the Organization for Economic Co-operation and Development (OECD), and the Administration's position regarding the pursuit of taxation relief for Hong Kong enterprises engaged in the trading of IPRs with entities in other jurisdictions

2. Like most other jurisdictions, Hong Kong adopts the OECD Model Tax Convention in our comprehensive avoidance of double taxation agreement (CDTA) negotiations. Under the OECD Model Tax Convention, taxing rights on royalties are handled under Article 12 – Royalties[1]. Accordingly, royalties arising from the use of IPRs can be dealt with under this Article. Under Article 12 of the CDTAs that Hong Kong concluded with other jurisdictions, Hong Kong residents usually enjoy lower tax rates for withholding tax imposed by the source state on the royalties received by Hong Kong residents from the enterprises of the source state.

3. Profits from the trading of IPRs are covered by the OECD Model Tax Convention under Article 7 – Business Profits. Under this Article, the business profits of an enterprise of one jurisdiction is taxable in the other jurisdiction only if it carries on business through a permanent establishment situated therein. In other words, cross-border business profits (including profits from the trading of IPRs) of an enterprise without a permanent establishment situated in the source state would not be, because of the CDTA, subject to tax in the source state.

4. If an enterprise suffers from double taxation (including taxes on royalties and business profits), it can claim tax credits with the resident jurisdiction so as to eliminate double taxation to the extent not exceeding the amount of tax computed in respect of that income according to the tax laws of that jurisdiction. It follows that any double taxation suffered by Hong Kong enterprises engaging in the trading of IPRs with entities in other jurisdictions with which Hong Kong has entered into CDTAs can be eliminated. This double taxation relief also applies in the case where the enterprise has paid the reduced withholding tax on royalties provided under the respective CDTAs.

5. According to our experience, our treaty partners also adopt the above-mentioned articles of the OECD Model Tax Convention in their CDTAs to deal with royalties arising from the use of IPRs and profits arising from the trading of IPRs. There are no other dedicated provisions on the taxation treatment of IPRs in our treaty partners' CDTA model texts.

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[1] The term "royalties" as used in the Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience.

To provide a comparison of the taxation arrangements proposed in the Bill with those of comparable jurisdictions, including relevant arrangements in the Mainland where appropriate

6. Based on the information available, the Administration has compiled a table (in English only) at **Annex** comparing the taxation arrangements proposed in the Bill with those of comparable jurisdictions, namely Australia, Canada, Singapore and the United Kingdom (UK). Relevant arrangements in the Mainland China are also set out in the table at the request of Members.

7. As far as the scope of tax deduction is concerned, it is common for other jurisdictions to provide tax deduction for the three types of IPRs covered by the Bill (i.e. copyrights, registered designs and registered trade marks), except in Australia where trade marks are not tax deductible. Our proposal of spreading the tax deduction over five succeeding years on a straight-line basis is on par with Singapore and more favourable than the other jurisdictions.

8. Regarding conditions for tax deduction, same as the other tax jurisdictions, our proposed tax deduction would be provided to taxpayers if the IPRs purchased are used for production of chargeable profits and the IPRs, for which registration systems are available, have been registered.

9. We have also proposed that taxpayers must possess the proprietary interest of the IPRs in order to be eligible for the proposed tax deduction. Singapore also requires the taxpayers to have the legal and economic ownership of the IPRs concerned for claiming the tax deduction. While it is noted that some jurisdictions such as Australia, Canada and UK do not impose similar requirement on the taxpayers, we would like to point out that these jurisdictions levy capital gains tax and could therefore uphold "tax symmetry" even though they allow the licensing fees in a lump sum paid by the licensees as deductible capital expenditure because the licensing fees so received by the licensors are taxable capital receipts.

10. The situation in Hong Kong is different as we do not tax capital receipts. If we were to extend the tax deduction proposed in the Bill to lump-sum licensing fees which are capital in nature, in order to maintain "tax symmetry" to avoid revenue loss, we would have to tax on the corresponding licensing fees so received by the licensors. This would be a fundamental deviation from our established and long-cherished principle of not charging tax on capital gains. On this, we do not

intend to provide tax deduction for lump-sum licensing fees which are capital in nature. Instead, under the existing Inland Revenue Ordinance, licensing payments which are revenue in nature are tax deductible, and correspondingly licensing fees received as revenue income are subject to tax.

11. In essence, in considering how certain tax deductions should be granted, all jurisdictions uphold the principle of "tax symmetry" in order to avoid revenue loss and potential abuses. This also explains why Singapore does not allow tax deduction for licensing payments which are capital in nature as Singapore, like Hong Kong, does not levy capital gains tax.

12. On the taxing of proceeds from the sale of the IPRs for which tax deductions have been granted, our proposed treatment is similar to the arrangement in Singapore and is more generous than that in other jurisdictions since only sales proceeds capped at the deductions previously allowed would be brought to tax as opposed to the taxing of full sales proceeds in other jurisdictions where capital gains tax is charged.

To set out in writing the various scenarios cited by members and explain the applicability of the proposed tax deduction for each scenario

13. We will set out the tax treatment for various scenarios later on together with the Administration's responses to deputations' submissions. The comparison of anti-avoidance provisions in other jurisdictions will also be provided in that context.

To provide information on relevant arrangements under the Closer Economic Partnership Arrangement (CEPA) and the view of the Mainland authority on transfer pricing

14. CEPA covers three broad areas, namely trade in goods, trade in services, and trade and investment facilitation. For trade in goods, Hong Kong products that have fulfilled the CEPA origin rules as agreed by Hong Kong and the Mainland can enjoy zero tariff when importing into the Mainland. For trade in services, Hong Kong service suppliers can

now enjoy preferential treatment when setting up business in 44 service sectors in the Mainland. For trade and investment facilitation, the two sides have agreed to strengthen co-operation in ten areas[2]. There are no specific provisions under CEPA dealing with taxation matters.

15. On the issue of transfer pricing, the State Administration of Taxation has confirmed that if a Hong Kong enterprise provides 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 which would be sold to the Hong Kong enterprise at a price below normal price, such arrangement may constitute an "offsetting transaction" under the "Implementation Measures of Special Tax Adjustments (Provisional)" (Guoshuifa [2009] No.2) of the Mainland. In the course of conducting transfer pricing investigations, the Mainland tax authorities will make transfer pricing adjustments to restore the offsetting transactions.

Yours sincerely,

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

c.c.	Commissioner of Inland Revenue	(Attn: Mr Wong Kuen-fai)
	Department of Justice	(Attn: Miss Betty Cheung)

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[2] The relevant co-operation areas are trade and investment promotion; customs clearance facilitation; commodity inspection and quarantine, food safety, quality and standardisation; electronic business; transparency in laws and regulations; co-operation of small and medium enterprises; co-operation in industries; protection of intellectual property; co-operation on branding; and co-operation on education.

Annex

Tax Deduction for Capital Expenditure Incurred on the Purchase of Intellectual Property Rights (IPRs)

		Hong Kong's proposal	Australia	Canada	Mainland China	Singapore	United Kingdom
(a)	**Whether tax deduction is provided for capital expenditure incurred on the purchase of patent, know-how, copyright, registered design and registered trade mark**	The Inland Revenue (Amendment) (No. 2) Bill 2011 ("the Bill") has proposed to grant tax deduction for capital expenditure incurred on the purchase of copyright, registered design and registered trade mark. *(Note: Under the existing Inland Revenue Ordinance, tax deduction has already been provided for capital expenditure incurred on the purchase of patent and know-how.)*	Capital allowance deduction is provided for patent, copyright and registered design.	Tax deduction is provided for capital cost or capital expenditure incurred on the five IPRs.	Tax deduction is provided for capital cost or capital expenditure incurred on patent, know-how, copyright and registered trade mark.	Writing-down allowance ("WDA") is provided for capital expenditure incurred in acquiring the five IPRs from 1 November 2003 to 31 October 2013.	Amortization deduction is provided with respect to capital expenditure incurred on the five IPRs.

		Hong Kong's proposal	Australia	Canada	Mainland China	Singapore	United Kingdom
(b)	**Tax deduction period**	As proposed in the Bill, tax deduction will spread over 5 succeeding years on a straight-line basis for copyright, registered design and registered trade mark. *(Note: At present, one-off tax deduction is provided for patent and know-how.)*	Tax deduction is provided for the decline in value of the IPRs. The decline in value of an IPR is calculated on the basis of the statutory effective life and using the straight-line basis (i.e. 6 to 20 years for patent; 15 years for registered design and at most 25 years for copyright).	For IPRs with limited life, tax deduction spreads over the life of the IPRs on a straight-line basis. For IPRs with unlimited life, tax deduction is provided for three-quarters of the cost and amortised at 7% per annum on a declining balance basis.	Tax deduction spreads over a period of not less than 10 years or, if applicable, equivalent to the period specified in the contracts. Deduction is made on a straight-line basis.	WDA is provided over 5 years on a straight-line basis.	Tax deduction is provided over a period equivalent to the amortization charged to the accounts.
(c)	**Conditions for tax deduction for capital expenditure incurred on IPRs**						
	(i) Whether registration of the IPRs is required for tax deduction purpose	For design and trade mark where registration systems are available, registration is a pre-requisite for claiming tax deduction. Either local or overseas registration is acceptable.	For claiming tax deduction for IPRs, a person should be under Commonwealth law or equivalent rights under foreign law the patentee, or the owner of a registered design or a copyright, or	For tax deduction purpose, the IPRs must be registered if registration is required for the existence of the IPRs.	For tax deduction purpose, the IPRs must be registered if registration is required for the existence of the IPRs.	For tax deduction purpose, the IPRs must be registered if the IPRs are registrable. Either local or overseas registration is acceptable.	For tax deduction purpose, the IPRs must be registered if registration is required for the existence of the IPRs.

		Hong Kong's proposal	Australia	Canada	Mainland China	Singapore	United Kingdom
		The registration requirement is not applicable to copyrights as there is no official registry in Hong Kong for registration of copyright works.	the licensee of any of those items.				
	(ii) Whether the taxpayer must possess the proprietary interest of the IPRs	Yes, the taxpayer must possess the proprietary interest of the IPRs.	No, there is no requirement that a taxpayer has to be the owner or quasi owner of an IPR in order to qualify for the capital allowance deduction in respect of that IPR. Instead, a taxpayer is entitled to the capital allowance deduction for IPRs that they "held" for any time during the income year.	No, expenses incurred in obtaining licences of IPRs are also eligible for tax deduction.	No, expenses incurred in acquiring the right of use of IPRs are also eligible for tax deduction.	Yes, a taxpayer must possess the legal and economic rights of the acquired IPRs.	No, expenses incurred in obtaining licences of IPRs are also eligible for tax deduction.

		Hong Kong's proposal	Australia	Canada	Mainland China	Singapore	United Kingdom
			In general, the owner, or the legal owner if there is both a legal and equitable owner of an IPR is the holder of the IPR.				
	(iii) Whether the IPRs must be used for production of chargeable profits	The IPRs must be used to produce profits chargeable to tax in Hong Kong.	The IPRs must be used to generate taxable income.	The IPRs must be acquired for the purpose of gaining or producing income that is not exempt from tax in Canada.	The IPRs must be used in a company's trade or business.	Where a company is carrying on a trade or business, the IPRs must be acquired for use in the trade or business for the purpose of income tax assessment.	The IPRs must be used by a company on a continuing basis in the course of its activities, and that the company must be within the charge of corporate tax of the United Kingdom.
(d)	**Claw-back rules**	Only sales proceeds capped at the deductions previously allowed would be brought to tax.	Full sales proceeds will be brought to tax.	Full sales proceeds will be brought to tax.	Full sales proceeds will be brought to tax.	Only sales proceeds capped at the WDA previously allowed would be brought to tax.	Full sales proceeds will be brought to tax.

Important Note:

The above information is for reference only. While every effort is made to ensure the accuracy of the above information, the Government of the Hong Kong Special Administrative Region cannot guarantee this to be so and will not be held liable for any reliance placed on the same.

Financial Services and the Treasury Bureau
May 2011