Tax Deduction for Capital Expenditure Incurred on the Purchase of Intellectual Property Rights ("IPRs") under the Existing Provisions of the Inland Revenue Ordinance and the Proposed Provisions in the Inland Revenue (Amendment)(No.2) Bill 2011

Scenario 1 - If a specified IPR is partially owned by a taxpayer

The Administration's response -

According to the Inland Revenue (Amendment) (No. 2) Bill 2011 ("the Bill"), where a specified IPR is owned by more than one taxpayer, the proposed tax deduction for each taxpayer will be granted for the amount of capital expenditure that is proportional to his/her share in the legal ownership of the specified IPR.

Scenario 2 - If a taxpayer has obtained a licence from the owner of a specified IPR for use of the specified IPR over a specified period of time. In addition to the annual licensing fee, the taxpayer has paid an upfront fee to the IPR owner for the licence.

The Administration's response -

2. Under the licensing arrangement, the taxpayer has not acquired the ownership of the specified IPR. Hence, under the Bill, the taxpayer is not eligible to claim tax deduction for the payment (including both the upfront fee and the annual licensing fee) made for the IPR licence.

3. However, under the existing section 16 of the Inland Revenue Ordinance ("IRO"), tax deduction is provided for revenue expenditure incurred for producing chargeable profits. As the annual licensing fee paid by the taxpayer for the use of the specified IPR is a recurrent expenditure, it is already deductible under the existing IRO.

4. A very important feature of our taxation system is that we do not tax capital receipts and by symmetry do not allow deduction of capital expenditure. In this regard, the existing section 17(1)(c) of the IRO specifically disallows the

deduction of any expenditure of a capital nature unless it is otherwise explicitly stated in other sections of the IRO[1]. By the same token, the existing section 14(1) of the IRO excludes any capital receipts as assessable profits. In short, the upfront fee of an IPR licence, which is capital in nature, paid by the licensee is not deductible and the corresponding upfront payment earned by the licensor is not taxable either.

Scenario 3 - If a taxpayer has purchased a patent registered in the United States ("US") and subsequently conducted research and development ("R&D") in Hong Kong with that patent to create a new product.

The Administration's response -

5. Under the existing section 16B of the IRO, tax deduction is provided for any expenditure on R&D related to the taxpayer's trade, profession or business carried out in Hong Kong.

6. Since registration and protection of patents operate on a territorial basis, if a taxpayer wants to enjoy protection in Hong Kong for the invention that is the subject matter of a US patent and for any other invention made using that invention in its R&D conducted in Hong Kong, he/she should apply for registering the US patented invention and the other new invention in Hong Kong. If the taxpayer uses the Hong Kong patent for producing profits chargeable to tax in Hong Kong, the Inland Revenue Department ("IRD") will provide tax deduction for capital expenditure incurred on the purchase of the ownership of the Hong Kong patent under the existing section 16E of the IRO.

Scenario 4 - If the sale and purchase transaction of an IPR is conducted in Hong Kong and the IPR is used outside Hong Kong by the taxpayer after the purchase

The Administration's response -

7. Tax deduction for the purchase cost of the IPR will be granted to the taxpayer if, during a part or the whole of the basis period for a year of assessment, -

[1] For example, the existing section 16E allows tax deduction for capital expenditure incurred on the purchase of patent rights and rights to any know-how.

(a) the IPR has been used by the taxpayer himself/herself outside Hong Kong;

(b) the IPR subsists (in the case of copyrights) or, if applicable, the registration of the IPR is in force where the IPR is used (in the case of designs or trade marks);

(c) the IPR has been used for production of profits chargeable to tax in Hong Kong; and

(d) the taxpayer still possesses the ownership of the IPR (i.e. the IPR has not been sold by the taxpayer) at the end of the basis period.

Scenario 5 - Tax deduction arrangements for IPRs involved in cross-border activities

The Administration's response -

8. For IPRs involved in cross-border activities such as the case where a Hong Kong enterprise has arranged a Mainland enterprise to produce in the Mainland finished goods with a registered design which would subsequently be sold in Hong Kong, there may be two registered designs involved, i.e. a registered design in Hong Kong and another registered design in the Mainland as the registration and protection of IPRs operate on a territorial basis. If the Hong Kong enterprise would like to have protection on the relevant design both in the production process and in the sale of the goods, the design should be registered in the Mainland and Hong Kong separately.

9. If the Hong Kong enterprise has purchased at the same time the two IPRs as mentioned above, i.e. the Hong Kong registered design and the Mainland registered design, the tax deduction arrangements for these two IPRs would depend on the mode of operation of the Hong Kong enterprise.

10. If the Hong Kong enterprise is engaged in "contract processing", the Hong Kong enterprise is responsible for supplying all necessary raw materials and production equipment including the Mainland registered design used in the production of the finished goods concerned. The "contract processing factory" of the Mainland is basically responsible for processing the raw materials according to the instructions and requirements of the Hong Kong enterprise.

The finished products so produced belong to the Hong Kong enterprise. The Mainland authorities strictly require that the finished products under "contract processing" should all be exported and the finished products would be sold by the Hong Kong enterprise. Based on the "territorial source" and "tax symmetry" principles, we allow the Hong Kong enterprise engaging in "contract processing" to apportion its profits derived from the Mainland production activities on a 50:50 basis for assessment of Hong Kong profits tax. Accordingly, we allow 50% deduction of expenses incurred by the Hong Kong enterprise for production of the above assessable profits, including the capital expenditure incurred on the purchase of the Mainland registered design and the Hong Kong registered design.

11. However, under "import processing", the Mainland enterprise responsible for the Mainland production activities is an independent legal entity. The profits derived by the Mainland enterprise from the production activities in the Mainland are subject to the Mainland taxes. According to the "territorial source" principle, the IRD would not charge profits tax on the Hong Kong enterprise in relation to the Mainland production activities. Based on the "tax symmetry" principle, the Hong Kong enterprise is also not eligible for tax deduction for capital expenditure incurred on the purchase of the Mainland registered design which is solely used in the production activities in the Mainland. That said, when the finished goods produced by the Mainland enterprise are traded in Hong Kong by the Hong Kong enterprise, such goods then carry the Hong Kong registered design. The Hong Kong enterprise is eligible to claim tax deduction for capital expenditure incurred on the purchase of the Hong Kong registered design which has been used for production of its trading profits chargeable to tax in Hong Kong.

12. The amount of tax deduction allowed would be determined by the actual expenditure incurred by the Hong Kong enterprise in purchasing the Mainland registered design and the Hong Kong registered design. If the Mainland registered design and the Hong Kong registered design are purchased for one consideration and there is no apportionment in price for each registered design, the Commissioner of Inland Revenue ("the Commissioner") will, having regard to all the circumstances of the relevant transaction, allocate the purchase price of individual registered designs based on professional advice as appropriate. Conversely, if there is apportionment in price for the Mainland registered design and the Hong Kong registered design at the time of purchase, it will not be necessary for the Commissioner to allocate the purchase price of individual registered designs.

13. The taxation arrangement for the Mainland registered design used in "import processing" as stated above is in line with our taxation arrangement for machinery and plant used in the Mainland production activities under "import processing". Similarly, based on the taxation principles of "territorial source" and "tax symmetry", we could not provide tax deduction for capital expenditure incurred on the purchase of the Mainland registered design used solely by the Mainland enterprise in the Mainland production activities for production of profits chargeable to Mainland tax.

14. In addition, as confirmed by the State Administration of Taxation, if a Hong Kong enterprise provides the Mainland registered intellectual property to its associated enterprise in the Mainland at no rent 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. If the Mainland tax authorities make transfer pricing adjustments, IRD has to make corresponding adjustments to the amount of tax charged in Hong Kong in accordance with the "Arrangement between the Mainland of China and the Hong Kong Special Administrative Region for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income". Given that the Hong Kong enterprises and the Mainland enterprises are associated parties in many cases, if we were to provide tax deduction for capital expenditure incurred on the purchase of the Mainland registered intellectual property used in the Mainland production activities, we might be perceived as acting in violation of the "arm's length principle" and encouraging transfer pricing arrangements disapproved by the tax authorities of other jurisdictions.

Financial Services and the Treasury Bureau
June 2011