CB(1)2853/10-11(01)

財 經 事 務 及 庫 務 局
（ 庫 務 科 ）
香 港 下 亞 厘 畢 道
中 區 政 府 合 署

FINANCIAL SERVICES AND THE TREASURY BUREAU
(The Treasury Branch)
Central Government Offices,
Lower Albert Road,
Hong Kong

傳真號碼 Fax No. : 2234 9757
電話號碼 Tel. No. : 2810 2229
本函檔號 Our Ref. :
來函檔號 Your Ref. :

1 August 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

I refer to your letter dated 13 July 2011. Please find attached at **Annex A** the Administration's response to the submission dated 5 July 2011 from the Joint Liaison Committee on Taxation and the submission dated 6 July 2011 from the Hong Kong Institute of Certified Public Accountants. The Administration's reply to the issues raised by Members at the last meeting held on 7 July 2011 is also set out in the ensuing paragraphs.

To provide examples to facilitate members' understanding of the apportionment arrangement under the proposed section 16E(2)

2. We have prepared at **Annex B** an example to demonstrate the apportionment arrangement under the proposed section 16E(2). The Administration wishes to emphasize that the Inland Revenue Department ("IRD") has been adhering to the basic principles and general rules for apportionment that have already been set out respectively in the existing section 16(1) of the Inland Revenue Ordinance (Cap. 112) ("IRO") and

the Inland Revenue Rules (Cap. 112 sub. leg. A) in determining the amount of deduction currently allowable under the existing section 16E of the IRO for patent rights and rights to any know-how which are partly used for the production of chargeable profits. The IRD would take into account all relevant facts of individual cases in determining the extent of the use of a patent right or right to any know-how in the production of chargeable profits. The example at **Annex B** is solely a hypothetical case drawn up for illustrative purpose.

To consider using the same term, i.e. either "true value" or "true market value", in the IRO to eliminate potential ambiguity

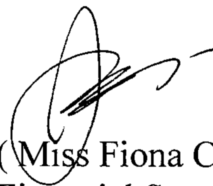
3. The power of the Commissioner of Inland Revenue to determine true market value of an asset for tax purpose is not new under the IRO. Currently, similar powers are provided for in section 16G (on prescribed fixed asset), section 16J (on environmental protection facilities) and section 38B (on commercial, industrial buildings, machinery and plant) of the IRO. The term "true market value" is consistently used in all the above three cases except that the section heading of section 38B uses the term "true value". As made clear by section 18(3) of the Interpretation and General Clauses Ordinance (Cap. 1), a section heading does not have any legislative effect and does not in any way vary, limit or extend the interpretation of any Ordinance. The section heading merely serves as an aid to the reader. In this regard, the Administration considers that it is appropriate to adopt the term "true market value" in the relevant provisions proposed in the Inland Revenue (Amendment) (No. 2) Bill 2011.

To consider whether the drafting of section 16EC(1)(b) should be refined to reflect the policy intent

4. The Administration is of the view that if an intellectual property right ("IPR") is purchased by the licensee from the licensor, the licence of the IPR will be terminated (either by implied agreement between the parties or by operation of law). In this regard, even though no extra step has been taken to terminate a licence of IPR, "termination of a licence of IPR by implied agreement between the parties or by operation of law" still constitutes "termination of a licence of IPR". In other words, even though no specific step has been taken to terminate the licence for the IPR which has been purchased by the licensee from the licensor, section 16EC(1)(b) would be met as the licence was still terminated by implied agreement between the parties or by operation of law. Accordingly, the

Administration considers that the reference to "the licence was terminated before that expiry date" in the proposed section 16EC(1)(b) reflects the policy intent and would not pose a hurdle to the IRD in invoking section 16EC.

Yours sincerely,



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

<u>Encls</u>

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

Annex A

Inland Revenue (Amendment) (No. 2) Bill 2011 ("the Bill")
The Administration's Responses to the Second Batch of Submissions from Deputations

Item No.	Views/Comments from Deputations	Organisations	The Administration's Responses
Anti-avoidance Provisions			
1.	A Hong Kong enterprise, in allowing its sub-contractor to use outside Hong Kong the intellectual property right ("IPR") it owns to manufacture products that it orders to be made, aims to derive profits from the trading of the finished products manufactured by the sub-contractor. As such, as long as the profits derived from the trading activities are chargeable to tax in Hong Kong, the expenses incurred in purchasing the IPR should be deductible. The proposed section 16EC(4)(b) of the Bill should therefore be deleted.	JLCT	The Administration does not agree to this point. The Administration has pointed out repeatedly that under "import processing", the sub-contractor responsible for the production activities in the Mainland is an independent legal entity. The profits derived by the sub-contractor from the production activities in the Mainland are subject to the Mainland taxes. According to the "territorial source" principle, the Inland Revenue Department ("IRD") would not charge profits tax on that sub-contractor 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 IPR which is provided to the sub-contractor and solely used in the production activities in the Mainland.
2.	Since one of the conditions for tax deduction is that the relevant IPRs must be used for the production of chargeable profits in Hong Kong, it is not necessary to add the proposed section 16EC(4)(b). There are well established principles to determine the source of profits and there has been a	HKICPA JLCT	As indicated in the Administration's Part II responses to deputations' submissions on 10 June 2011, the policy intent of the Bill is to provide tax deduction only for the IPRs which are used for the production of chargeable profits in Hong Kong. Such policy intent has been clearly illustrated by way of the existing section 16E(1) and the proposed section 16EA(2). Such policy is also applicable to cross-border transactions. That is, taxpayers could only claim tax deductions for the IPRs which are used by the

Item No.	Views/Comments from Deputations	Organisations	The Administration's Responses
	good deal of case law on this subject. As such, deletion of the proposed section 16EC(4)(b) would not create uncertainty in the legislation.		taxpayers "themselves" in the cross-border transactions for production of profits chargeable to tax in Hong Kong. The Administration has indicated in the Legislative Council Brief issued on 23 February 2011 (please refer to paragraphs 4 and 7, file ref: TsyB R 183/535-1/8/0 (10-11)(C)) that deduction would be granted for capital expenditure on the purchase of IPRs irrespective of whether they are used in Hong Kong as long as they are used by the taxpayers "themselves" for production of chargeable profits. In order to reflect such policy clearly and to avoid unnecessary disputes, we consider it necessary to include the proposed section 16EC(4)(b) to state beyond doubt that IPRs used outside Hong Kong by another party would not be eligible for tax deduction purpose in Hong Kong as such IPRs are not used for the production of profits chargeable to tax in Hong Kong. Deleting the proposed section 16EC(4)(b) will create uncertainty in the legislation, thus providing opportunities for enterprises to take advantage of such to obtain tax deduction for IPRs used by other entities outside Hong Kong. Apart from violating the tax principles of Hong Kong, this will also result in loss in our tax revenue. When considering any tax deduction proposals, it is fundamental that we have due regard to the overall interest of taxpayers in Hong Kong. Hence, we consider it necessary to include the proposed section 16EC(4)(b).
3.	If a Hong Kong enterprise provides IPRs to its associated enterprise in the Mainland rent-free for production of finished products which are then sold to	JLCT	Regarding the issue of offsetting transactions arising from cross-border activities, we have indicated repeatedly to the Legislative Council and the Bills Committee that we have obtained confirmation from the State Administration of Taxation ("SAT")

Item No.	Views/Comments from Deputations	Organisations	The Administration's Responses
	the Hong Kong enterprise at a price below normal price, such arrangement does not constitute an offsetting transaction.		that such arrangement may constitute an offsetting transaction under the "Implementation Measures of Special Tax Adjustments (Provisional)" (Guoshuifa [2009] No.2) of the Mainland. The Mainland tax authorities will make transfer pricing adjustments to restore the offsetting transactions and 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".
4.	How Hong Kong formulates or administers its tax law will have no impact on the taxing rights of other tax jurisdictions under the transfer pricing principles. Nor will it undermine the taxing rights of other tax jurisdictions to make transfer pricing adjustments. As such, if Hong Kong sets out in its domestic legislation that deduction would be provided to IPRs used outside Hong Kong by a person other than the taxpayer for production of profits not chargeable to Hong Kong tax, this would not affect the taxing rights of other tax jurisdictions. Besides, for those economies with which Hong Kong has not entered into comprehensive agreements for	JLCT	The Administration does not agree to this view. The Organisation for Economic Co-operation and Development ("OECD") and tax authorities around the world are all increasingly concerned about the transfer pricing issue arising from cross-border transactions between associated enterprises. There is consensus among the tax authorities to prevent transfer pricing arrangements as far as possible in order to protect their respective tax revenue. Under normal arrangement, the manufacturing enterprise of the Mainland should reflect in the selling price of the finished products sold to the Hong Kong enterprise the total cost incurred in the Mainland manufacturing activities, including the rental fee for using the IPRs provided by the Hong Kong enterprise to the Mainland enterprise. However, under the transfer pricing arrangement, the Mainland enterprise will offset the rental fee for using the IPRs provided by the Hong Kong enterprise in the selling price of the finished products sold to that Hong Kong enterprise, making the selling price of the finished products lower than normal price. Since the profits tax rate of Hong Kong is generally lower than that

Item No.	Views/Comments from Deputations	Organisations	The Administration's Responses
	avoidance of double taxation ("CDTAs"), Hong Kong has no obligation to make corresponding adjustments to the amount of tax charged on the taxpayers concerned after tax adjustments have been made by these economies to restore offsetting transactions.		of the Mainland, the enterprises concerned can still gain tax benefit in the cross-border transactions even though the profits of the Hong Kong enterprise is now higher. Moreover, if the Hong Kong enterprise could obtain the proposed tax deduction for the above IPRs owned by it but provided for use by the Mainland enterprise, the transfer pricing arrangement may become even more effective in tax avoidance as the amount of Hong Kong tax deduction provided for the IPRs may well exceed the amount of "profits transferred" to Hong Kong. To protect tax revenue and to avoid disputes, it is necessary to introduce the anti-avoidance measure as provided in the proposed section 16EC(4)(b) to stipulate clearly that such arrangement could not enjoy the proposed tax deduction. If we were to follow the suggestion of the JLCT, the taxing rights of the Mainland would be affected in two ways. First, as Hong Kong enterprises provide IPRs to Mainland enterprises free of charge and no royalties are derived herefrom, they need not pay business tax and corporate income tax chargeable in the Mainland. Second, as the Mainland enterprises sell the finished products to the Hong Kong enterprises at a price below normal price, this will reduce the amount of tax collected by the Mainland authorities. On this score, the SAT has confirmed that they will conduct transfer pricing investigations and will make transfer pricing adjustments to restore offsetting transactions. Other jurisdictions will also adopt the same approach in handling transfer pricing arrangements to protect their tax revenue. If the SAT makes tax adjustments to restore the offsetting transactions, Hong Kong has to make corresponding tax adjustments, including adjusting the amount of the relevant

Item No.	Views/Comments from Deputations	Organisations	The Administration's Responses
			assessable profits so as to reflect all the costs incurred in relation to the Mainland manufacturing activities taking into account the rental fee paid by the Mainland enterprise for the IPRs provided by the Hong Kong enterprise. Although the Hong Kong enterprise has claimed that the IPRs are provided at no cost for use by the Mainland enterprise, the IPRs are indeed provided at cost as the consideration for using the IPRs is covered by the reduced selling price of the products. If we separate the relevant transactions, the royalty income earned from granting the right to use the IPRs outside Hong Kong is profits derived outside Hong Kong and hence not subject to tax in Hong Kong. Accordingly, the proposed tax deduction could not be provided for the capital expenditure incurred on the purchase of the relevant IPRs. Deleting the proposed section 16EC(4)(b) would render it very difficult to handle the above arrangement. Like other jurisdictions, Hong Kong will include in the CDTAs relevant provisions stipulating the taxing rights of the two contracting parties for transactions between associated enterprises of the two places in accordance with the "arm's length" principle advocated by the OECD. As a responsible tax jurisdiction, Hong Kong has to comply with all the provisions in the CDTAs. If we were to ignore the fact that the taxing rights of other tax jurisdictions would be affected and to allow tax deduction for IPRs used outside Hong Kong not by the taxpayer himself by way of removing the proposed section 16EC(4)(b), we will be perceived as acting in violation of the "arm's length" principle and in a way encouraging transfer pricing arrangements disapproved by the tax authorities around the world. Hong Kong will be criticised as a

Item No.	Views/Comments from Deputations	Organisations	The Administration's Responses
			harmful tax competitor.
5.	The proposed inclusion of section 16EC(4)(b) in the Bill will dilute the effect of removing the "use in Hong Kong" requirement for granting the tax deduction as proposed by the Administration.	JLCT	The Administration's proposal to remove the "use in Hong Kong" requirement aims at keeping the legislation in line with the development of Hong Kong enterprises in the globalised world economy. On the premise that the taxation principles of Hong Kong are met, Hong Kong enterprises will also be granted tax deduction for capital expenditure incurred on the purchase of the IPRs which are owned and used by themselves outside Hong Kong for production of profits chargeable to tax in Hong Kong. This is undoubtedly an enhancement compared with the current situation. The proposed inclusion of section 16EC(4)(b) in the Bill is only to disallow the proposed tax deduction for the IPRs which are used outside Hong Kong by persons other than the taxpayers themselves as these IPRs are not used for production of chargeable profits to Hong Kong. On this account, adding such section will not dilute the effect of removing the "use in Hong Kong" requirement.
6.	It is not clear whether a taxpayer will be eligible for tax deduction for capital expenditure incurred on the purchase of his IPR if he allows a local sub-contractor to use the IPR to manufacture in Hong Kong products that he orders to be made.	JLCT	As to whether a taxpayer will be eligible for tax deduction for capital expenditure incurred on the purchase of his IPR if he provides a sub-contractor in Hong Kong with that IPR he owns for use in Hong Kong, it depends on whether the arrangement is in compliance with the revised section 16(E)1 and the new section 16EA(2) as proposed in the Bill. That is to say, it depends on whether the IPRs used in Hong Kong by a person other than the taxpayer are for the production of chargeable profits of the taxpayer based on all the facts of individual cases.

Item No.	Views/Comments from Deputations	Organisations	The Administration's Responses
7.	The existing general anti-avoidance provisions in section 61A of the Inland Revenue Ordinance ("IRO") can be invoked to deal with cases where IPR transactions between unassociated entities are motivated by tax avoidance. Hence, it is not necessary to empower the Commissioner of Inland Revenue ("the Commissioner") to determine the true market value of IPR transactions.	HKICPA	The power of the Commissioner to determine true market value of an asset for tax purpose is not new under the IRO. Indeed, it is noted that the tax authorities of comparable jurisdictions are all empowered to determine for tax deduction purpose the true market value of the IPRs.
Registration Requirement			
8.	If a taxpayer has purchased an IPR, for which the registration application has not been approved at the time of purchase but has subsequently been approved with registration effective retrospectively from the day of the above purchase, it is not clear whether the taxpayer will be allowed to claim the proposed tax deduction.	JLCT	As indicated in the Administration's first batch of responses to deputations' submissions on 1 June 2011, recognising that the timeframe for registering IPRs varies, the IRD will adopt a liberal approach in considering tax deduction for IPRs undergoing registration process. Tax deduction would be provided as long as the IPRs concerned have already been registered by their previous owners, and the taxpayers purchasing the IPRs have already submitted applications for registering the IPRs under their names. However, if a taxpayer's application for change of ownership is not approved, the IPRs will not be eligible for the proposed tax deduction under the Bill. The IRD will raise additional assessment as appropriate to clawback any tax deduction previously allowed by virtue of section 60 of the IRO. For the scenario cited by the JLCT, whether the taxpayer will be eligible for the proposed tax deduction depends on the facts of the case. As a matter of principle, as long as the taxpayer, when

Item No.	Views/Comments from Deputations	Organisations	The Administration's Responses
			applying with the IRD for tax deduction for capital expenditure incurred on the purchase of the IPR, could provide documentary evidence to support that all the conditions for tax deduction as proposed in the Bill have been fulfilled, including that the registration of the IPR has been effective from a date not later than the day on which the taxpayer purchased the IPR, the taxpayer will be granted the tax deduction.
IPRs Used Overseas			
9.	The tax deduction arrangement is not clear if a taxpayer provides his overseas-registered IPR to an overseas manufacturer free of charge for the purpose of manufacturing overseas finished products which will then be put on sales by the taxpayer in the place of manufacture.	JLCT	In respect of the new section 16EC(4)(b) as proposed in the Bill, whether an IPR registered overseas is wholly or principally used overseas by a person other than the taxpayer is a matter of facts and should be considered on the merits of the case. For the example cited by the JLCT, different tax treatments should be adopted based on the uses of the IPR - ◆ Firstly, for use in overseas manufacturing activities, as the taxpayer allows the overseas manufacturer to use his IPR free of charge outside Hong Kong and all the finished products are wholly or principally produced overseas, the proposed section 16EC(4)(b) is applicable to the IPR used in such overseas manufacturing activities. Accordingly, the capital expenditure incurred on the part of the IPR which is used in manufacturing the finished products overseas is not eligible for tax deduction. ◆ For use in overseas sales, since the taxpayer puts on sales the finished products he owns, the IPR is not used by a person other than the taxpayer. As such, the proposed section

Item No.	Views/Comments from Deputations	Organisations	The Administration's Responses
			16EC(4)(b) is not applicable to the IPR used in overseas sales. The capital expenditure incurred on the part of the IPR which is used in the sales of the finished products overseas is eligible for tax deduction provided that other tax deduction conditions (including the use of the IPR in producing profits chargeable to tax in Hong Kong) are met. The tax deduction arrangements mentioned above are in line with the revised section 16E(2) and the new section 16EA(7) as proposed in the Bill. That is to say, if the IPR is used partly in the production of profits chargeable to tax in Hong Kong, the deduction allowable for the capital expenditure should be proportionate to the extent of the use of the IPR in the production of profits chargeable to tax. For the IPR mentioned in the quoted example, only the capital expenditure incurred on the part of the IPR used by the taxpayer in overseas sales for the production of profits chargeable to tax in Hong Kong is eligible for tax deduction.
10.	The tax deduction arrangement is not clear if a taxpayer purchases the proprietary interest of a trade mark with registration in ten different jurisdictions but he only uses the registered trade mark in six of those jurisdictions for the production of profits chargeable to tax in Hong Kong. The Administration should grant tax deduction for the taxpayer for his capital expenditure incurred on the purchase of the registered trade mark in all ten	JLCT	The Bill stipulates that if an IPR is used for the production of profits chargeable to tax in Hong Kong, the capital expenditure incurred on the purchase of the IPR is tax deductible. In the example cited by the JLCT, the taxpayer claims that the purpose of purchasing the proprietary interest of a trade mark registered in the remaining four jurisdictions is to protect the profits produced by the sales of goods carrying the registered trade mark in the first-mentioned six jurisdictions. This is a matter of facts and evidence. As the protection of IPRs operates on a territorial basis, the IRD would accept the above claim only if the taxpayer could provide substantive and reasonable evidence to prove that the registered trade mark he purchased in the remaining four jurisdictions has

Item No.	Views/Comments from Deputations	Organisations	The Administration's Responses
	jurisdictions as the purpose of the taxpayer purchasing the proprietary interest of the registered trade mark in the remaining four jurisdictions is to protect the profits produced by using the registered trade mark in the six jurisdictions.		direct and actual impact on the profits chargeable to tax in Hong Kong produced by the sales of goods carrying the registered trade mark in the first-mentioned six jurisdictions.
IPRs developed in-house or under a cost-sharing arrangement [1]			
11.	Payments made by taxpayers to non-approved research institutes for developing IPRs should be tax deductible.	HKICPA	The existing section 16B of the IRO provides tax deduction to taxpayers for expenditure incurred on research and development ("R&D"). In order to avoid abuse, the Administration has to be prudent in granting the above tax deduction. Taxpayers who wish to obtain tax deduction for expenditure on R&D must fulfill the following conditions – (a) the relevant R&D payments are made to approved research institutes; or (b) the relevant R&D is conducted by the taxpayer himself related to his trade, profession or business. An approved research institute is defined to mean any university, college, institute, association or organization which is approved in writing for the purposes of section 16B by the Commissioner as an institute, association or organization for undertaking R&D which is

[1] Where a Hong Kong taxpayer co-develops an IPR with its overseas group companies and shares the related cost with those companies.

Item No.	Views/Comments from Deputations	Organisations	The Administration's Responses
			or may prove to be of value to Hong Kong. The purpose of putting in place the approval mechanism is to ensure that the relevant research institutes possess the capability of undertaking R&D which is of value to Hong Kong.
12.	Where a taxpayer adopts a cost-sharing arrangement under the "arm's length principle" for developing an IPR, he should be granted tax deduction for the R&D expenditure incurred under such arrangement that is proportionate to the extent of his share in the ownership of the IPR so developed.	HKICPA	The existing section 16B of the IRO does not prohibit tax deduction for R&D expenditure incurred under a cost-sharing arrangement. As long as the taxpayer has fulfilled the following conditions – (a) the relevant R&D payments are made to approved research institutes; or (b) the relevant R&D is conducted by the taxpayer himself related to his trade, profession or business, the R&D expenditure incurred by him under the cost-sharing arrangement for the development of the part of the IPR he owns is also deductible.

Abbreviations for Organisations

HKICPA The Hong Kong Institute of Certified Public Accountants
JLCT The Joint Liaison Committee on Taxation

Financial Services and the Treasury Bureau
August 2011

Annex B

Example demonstrating the apportionment arrangement under the proposed section 16E(2)

Company P purchased a right to know-how in Year 1 (i.e. the year of purchase) at a cost of $20M and derived the following income from the use of the know-how in Year 1 –

(a) Income chargeable to tax in Hong Kong

Company P carried on business in Hong Kong and engaged in the sale of products by using the know-how to customers. Company P is subject to Hong Kong tax in relation to the profits derived from trading of the products. It is assumed that Company P derived a gross profit of $1M from the sale of the products in Year 1.

(b) Income not chargeable to tax in Hong Kong

By a licensing arrangement, Company P granted an exclusive licence to Company J to use the know-how in Japan at a royalty computed on the quantity of the products by using the know-how sold by Company J. The royalty paid by Company J for the use of the know-how is derived outside Hong Kong and hence not chargeable to profits tax in Hong Kong. It is assumed that Company P derived royalty income of $1.5M from Company J in Year 1.

As seen from the above, the know-how was partly used in the production of chargeable profits and partly for other purpose in Year 1. According to the proposed section 16E(2), Company P could only obtain deduction for the part of the capital expenditure incurred on the purchase of the know-how that is proportionate to the extent of the use of the know-how in the production of chargeable profits (i.e. (a) above). The amount of allowable deduction is computed as follows -

- Proportion of use of the know-how by Company P in the production of chargeable profits
  = (gross profit) ÷ (gross profit + royalty income)
  = ($1M) ÷ ($1M + $1.5M) x100% = 40%

- The amount of allowable deduction to Company P
  = \$20M x 40%
  = \$8M