

LEGISLATIVE COUNCIL BRIEF

Inland Revenue Ordinance
(Chapter 112)

INLAND REVENUE (AMENDMENT) (NO. 2) BILL 2011

INTRODUCTION

A At the meeting of the Executive Council on 15 February 2011, the Council ADVISED and the Chief Executive ORDERED that the Inland Revenue (Amendment) (No. 2) Bill 2011 (“the Bill”) at **Annex A** be introduced into the Legislative Council (“LegCo”). The Bill aims to implement the 2010-11 Budget initiative in respect of profits tax deduction for capital expenditure incurred on the purchase of copyrights, registered designs and registered trade marks.

JUSTIFICATIONS

2. To promote the wider application of intellectual property rights (“IPRs”) by enterprises, to encourage innovation and upgrading and to facilitate development of creative industries in Hong Kong, the 2010-11 Budget proposed to provide profits tax deduction for capital expenditure incurred on the purchase of three commonly-used types of IPRs, namely copyrights, registered designs and registered trade marks (“specified IPRs”). Currently, tax deduction is granted for capital expenditure incurred on the purchase of patent rights and rights to any know-how¹. Given that these rights and the specified IPRs are of similar nature, we have taken the opportunity to review the relevant provisions of the current tax deduction. Details of the proposed new tax deduction and the proposed revisions to the existing tax deduction are set out in the ensuing paragraphs.

Patent rights and rights to any know-how

3. Under section 16E of the Inland Revenue Ordinance (“IRO”), full sales proceeds will be brought to tax upon sale of the patent rights and

¹ “Know-how” means any industrial information or techniques likely to assist in the manufacture or processing of goods or materials.

rights to any know-how for which tax deductions have been previously allowed. The rationale for such claw-back provision is that since deduction is granted for what was originally non-deductible capital expenditure, it is logical to subject to tax the normally exempt capital gains following the disposal of the rights. With evolution in the tax laws over the years, to date all the depreciation/deduction claw-back rules in the IRO, except that for patent rights and rights to any know-how, cap the extent of taxable sales proceeds at deductions previously allowed. We propose to take this opportunity to amend section 16E of the IRO such that the sales proceeds for patent rights and rights to any know-how to be brought to tax would be capped at deductions previously allowed. This is in line with our policy of not taxing capital gains.

4. With the globalisation of the world economy, business activities are no longer confined to Hong Kong. We propose to remove the “use in Hong Kong” condition currently applicable to the tax deduction for patent rights and rights to any know-how as no such requirement is imposed on other deductible capital assets under the IRO. In other words, tax deduction would be granted for capital expenditure on the purchase of patent rights and rights to any know-how irrespective of whether they are used in Hong Kong as long as they are used by the taxpayers themselves for production of chargeable profits.

5. However, the relaxations proposed in paragraphs 3 and 4 above may open possible loopholes for tax avoidance practices, including “sale and licence back” and “leveraged licensing” arrangements. To plug these potential loopholes, we propose to amend the IRO such that deduction will not be allowed for patent rights and rights to any know-how under “sale and licence back” and “leveraged licensing” arrangements, but there will be an escape clause for the above anti-avoidance measures so that normal business activities would not be affected. Some overseas jurisdictions like the United Kingdom and Australia have similar anti-avoidance measures.

6. Currently, though not explicitly stipulated in section 16E of the IRO, legal expenses and valuation fees incurred in connection with the purchase of patent rights and rights to any know-how are deductible provided that such expenditure is not deductible under any other provisions of the IRO. For the avoidance of doubt, we propose to take this opportunity to spell out this arrangement in section 16E of the IRO.

7. The above proposed arrangements will also be applicable to the specified IPRs (see paragraphs 10, 11 and 13 below).

Copyrights, registered designs and registered trade marks

Registration requirement

B 8. In determining the scope of the proposed tax deduction, we have made reference to the Copyright Ordinance (Cap. 528), Registered Designs Ordinance (Cap. 522) and Trade Marks Ordinance (Cap. 559) for the purpose of defining copyright, design and trade mark. A brief description of the specified IPRs is at **Annex B**. Like many other jurisdictions, Hong Kong runs statutory registration systems to provide territorial protection to registered trade marks and registered designs. However, copyright is an automatic right which arises when a work is created. In most of the jurisdictions including Hong Kong, it is not necessary to register a copyright in order to get protection. As such, there is no official registry in Hong Kong for registration of copyright works.

9. It is a common practice for enterprises to register their valuable IPRs under available registration regimes. As the registration regimes provide an effective means to ascertain the identity of the registered owners of IPRs, we will for the purpose of granting the proposed tax deduction, impose a registration requirement² for those IPRs for which registration systems are available, namely trade marks and designs but not copyrights. Registration in either Hong Kong or overseas would be recognised.

Conditions for tax concession

10. Apart from the registration requirement, we propose that taxpayers should fulfil the following conditions in order to be eligible for the proposed tax deduction -

- (a) Taxpayers must have acquired the “proprietary interest” of the specified IPRs. With the “proprietary interest” of an IPR, a taxpayer is able to exploit the IPR for further improvement or development, which is in line with the policy objective of encouraging innovation and upgrading;
- (b) The specified IPRs are in use for the production of chargeable profits;
- (c) Where a specified IPR is used partly in the production of chargeable profits, deduction is only allowed for the portion of capital expenditure that is relevant to the production of such chargeable profits; and

² Singapore also requires that, for claiming tax deduction, the acquired IPRs should be registered if the rights are protected by means of registration.

- (d) Where a specified IPR is owned by more than one taxpayer, tax deduction for each taxpayer is granted for the amount of capital expenditure that is proportional to his/her share in the specified IPR.

In line with the proposed amendment to the existing tax deduction for patent rights and rights to any know-how (see paragraph 3 above), we propose that sales proceeds of the specified IPRs to be brought to tax should be capped at deductions previously allowed.

Inclusion of “related or incidental capital expenditure”

11. Following the proposed amendment to the existing tax deduction for patent rights and rights to any know-how (see paragraph 6 above), we propose to set out clearly in the law that legal expenses and valuation fees incurred in connection with the purchase of the specified IPRs are deductible provided that such expenditure is not deductible under any other provisions of the IRO.

Tax deduction period

12. Taking into consideration the protection life of the specified IPRs³, we propose that tax deduction for the specified IPRs be spread over five succeeding years on a straight-line basis starting from the year of purchase. The proposed tax deduction period is on par with or more generous than similar tax concessions in other tax jurisdictions. In specific circumstances where a specified IPR reaches the end of its maximum period of protection within the five-year deduction period, we propose that the deduction be spread in equal amounts over the number of years during which the protection of the specified IPR subsists.

Anti-avoidance provisions

13. Similar to the other tax deduction items, tax deduction for capital expenditure on IPRs is prone to abuse. Hence, we propose to put in place the following commonly-used measures to guard against possible tax avoidance -

- (a) Deductions will not be allowed for the specified IPRs purchased wholly or partly from an associated party;

³ Registered trade mark rights can be perpetual provided that the registration is renewed every ten years. Depending on the type of copyright works, copyrights protection in Hong Kong can last for 25 years; 50 years; or the life of the author of the work plus 50 years posthumously. Design registration is valid up to 25 years provided that the registration is renewed every five years. As for patents, protection under short-term patents is renewable for a maximum term of eight years whereas protection under standard patents is renewable annually after the initial three years for a maximum term of 20 years.

- (b) Deduction will not be allowed for the specified IPRs under “sale and licence back” and “leveraged licensing” arrangements. An escape clause will be provided so that normal business activities would not be affected; and
- (c) The Commissioner of Inland Revenue (“CIR”) will be empowered to determine, where circumstances so warrant, the true market price for any sale or purchase transactions of the specified IPRs in respect of which a tax deduction is claimed. The deduction allowable should be restricted to the true market price so determined. CIR will also be empowered to allocate the purchase or selling price for individual specified IPRs having regard to all the circumstances of the transaction where the specified IPRs are purchased or sold together or with other asset(s) for a single price.

14. In line with paragraph 13(c) above, we also propose to empower CIR to determine, for the purpose of ascertaining profits chargeable to tax, the true market price of patent rights or rights to any know-how, or if those rights are purchased or sold together or with other assets for one consideration, to allocate a consideration for each of those rights.

15. To deter taxpayers from purchasing the specified IPRs that have already been used by them under a licence purely for tax benefits when the proposed tax deduction is introduced, as a transitional arrangement, a deduction will not be allowed where the taxpayer cancels the licence before its expiry and purchases the specified IPR at unreasonable consideration.

OTHER OPTIONS

16. We must amend the IRO in order to bring the relevant proposals into effect. There are no other options.

THE BILL

17. The major provisions of the Bill are as follows -

- (a) **Clause 5(1)** amends section 16E(1) of the IRO to remove the use in Hong Kong element from the condition for deduction of capital expenditure incurred on the purchase of patent rights or rights to any know-how that they must be used in Hong Kong in the production of profits chargeable to tax.
- (b) **Clause 5(5)** amends section 16E(3) of the IRO to provide that if a deduction has been allowed to a person under section 16E(1) of

the IRO in respect of patent rights or rights to any know-how, and those rights are subsequently sold by the person, the proceeds of the sale are to be treated as trading receipts only to the extent of the amount of the deduction as previously allowed.

(c) **Clause 5(10)** mainly adds the following provisions to the IRO -

- (i) a new section 16E(7) providing that if any patent rights or rights to any know-how in respect of which a deduction is allowable under section 16E(1) of the IRO are purchased or sold together or with any other assets for one consideration, the CIR may allocate a consideration for each individual right for the purposes of section 16E of the IRO; and
- (ii) a new section 16E(8) providing that if the CIR is of the opinion that the consideration for the purchase or sale of any patent rights or rights to any know-how does not represent the true market value of those rights, the CIR may determine the true market value for that purchase or sale for the purposes of section 16E of the IRO.

(d) **Clause 6** adds new sections 16EA, 16EB and 16EC to the IRO -

- (i) New section 16EA provides that any capital expenditure incurred on the purchase of a copyright, registered design or registered trade mark may be deducted in ascertaining profits chargeable to profits tax (over 5 succeeding years of assessment or a lesser number of years of assessment in the case of a copyright or registered design whose maximum period of protection is due to expire before the expiry of the basis period for the last of those 5 years of assessment). That section also provides for the conditions under which and the manner in which such a deduction is to be made.
- (ii) New section 16EB provides that if a deduction has been allowed to a person under the new section 16EA in respect of a copyright, registered design or registered trade mark, and the copyright, registered design or registered trade mark is subsequently sold by the person, the proceeds of the sale are to be treated as trading receipts in the manner specified in that section.
- (iii) New section 16EC provides for the non-deduction of expenditure in various circumstances and applies to patent rights and rights to any know-how as well as copyrights, registered designs and registered trade marks. The new section 16EC incorporates section 16E(2A) and (2B) of the IRO (on non-deduction of expenditure for purchase of patent

rights and rights to any know-how from an associate) repealed by Clause 5(4).

- (e) **Clauses 8 and 9** add a new section 89(7) and a new Schedule 22 which sets out transitional provisions.

LEGISLATIVE TIMETABLE

18. The legislative timetable will be as follows -

Publication in the Gazette	25 February 2011
First Reading and commencement of Second Reading debate	9 March 2011
Resumption of Second Reading debate, committee stage and Third Reading	To be notified

IMPLICATIONS OF THE PROPOSAL

19. The Bill is in conformity with the Basic Law, including the provisions concerning human rights. It has no productivity, environmental or civil service implications. The amendments proposed in the Bill will not affect the binding effect of the existing provisions of the IRO and its subsidiary legislation.

- C 20. The financial, economic and sustainability implications are set out at **Annex C**.

PUBLIC CONSULTATION

21. We briefed the Joint Liaison Committee on Taxation ("JLCT") and the LegCo Panel on Financial Affairs ("FA Panel") on the outline of our legislative proposals on 7 October 2010 and 1 November 2010 respectively. Our current proposals have already taken on board some of the JLCT's comments as appropriate. Members of the FA Panel mainly sought clarifications on the proposed features of the tax deduction for the specified IPRs. Subsequent to the above consultations, we came to notice that some revisions to the current tax deduction for patent rights and rights to any know-how are needed as well. We have also fine-tuned some of the proposed anti-avoidance measures, taking into account overseas experiences and the JLCT's concerns.

PUBLICITY

22. A press release on the Bill will be issued on 25 February 2011. A spokesperson will be available to answer media and public enquiries.

BACKGROUND

23. Under Hong Kong's tax system, an enterprise's revenue expenditure is generally deductible under profits tax. As such, an enterprise's revenue expenditure for the use of IPRs (e.g. royalties, licence fees and other forms of regular payments), like its other revenue expenditure, is deductible for profits tax purpose. As we do not tax capital gains, by symmetry we do not allow deduction of capital expenditure. If an enterprise purchases its IPRs, the purchase consideration which is capital in nature is generally not deductible with the exception of capital expenditure incurred on the purchase of patent rights and rights to any know-how. Besides, to promote protection of IPRs, tax deductions have been specifically provided for the registration expenditure incurred in Hong Kong or overseas on three specified types of IPRs, namely patent, trade mark and design. If an enterprise develops its IPRs other than in its ordinary course of business, the expenditure so incurred may still be deductible as long as it qualifies as "research and development".

ENQUIRIES

24. Enquiries on this Brief should be directed to Ms Shirley Kwan, Principal Assistant Secretary for Financial Services and the Treasury (Treasury) (Revenue) at 2810 2370.

Financial Services and the Treasury Bureau
23 February 2011

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A BILL To

Amend the Inland Revenue Ordinance to provide for the deduction in ascertaining profits chargeable to tax under the Ordinance of capital expenditure incurred on the purchase of a copyright, registered design or registered trade mark, to modify the provisions of the Ordinance governing such deduction of capital expenditure incurred on the purchase of patent rights and rights to any know-how, and to provide for incidental matters.

Enacted by the Legislative Council.

1. Short title

This Ordinance may be cited as the Inland Revenue (Amendment) (No. 2) Ordinance 2011.

2. Inland Revenue Ordinance amended

The Inland Revenue Ordinance (Cap. 112) is amended as set out in sections 3 to 9.

3. Section 15 amended (Certain amounts deemed trading receipts)

(1) Section 15(1)(b), English text—

Repeal

“trademark” (wherever appearing)

Substitute

“trade mark”.

(2) Section 15(1)(ba), English text—

Repeal

“trademark” (wherever appearing)

Substitute

“trade mark”.

4. Section 16 amended (Ascertainment of chargeable profits)

Section 16(1)(ga)—

Repeal

everything after “16E,”

Substitute

“16EA, 16F, 16G and 16I, as provided in those sections;”.

5. Section 16E amended (Purchase and sale of patent rights, etc.)

(1) Section 16E(1)—

Repeal

“in Hong Kong”.

(2) After section 16E(1)—

Add

“(1A) A deduction allowable under subsection (1) includes legal expenses and valuation fees incurred in connection with the purchase of any rights of a kind referred to in that subsection.”.

(3) Section 16E—

Repeal subsection (2)

Substitute

“(2) If any rights of a kind referred to in subsection (1) are used partly in the production of profits chargeable to tax under this Part and partly for any other purposes, the deduction allowable under this section is that part of the expenditure referred to in subsection (1) that is proportionate to the extent of the use of the rights in the

production of the profits chargeable to tax under this Part.”.

- (4) Section 16E—

Repeal subsections (2A) and (2B).

- (5) Section 16E—

Repeal subsection (3)

Substitute

- “(3) Despite the exclusion relating to the sale of capital assets in section 14, where any rights of a kind referred to in subsection (1) in respect of which a deduction has been allowed to any person under that subsection in ascertaining the profits from a trade, profession or business are subsequently sold by the person, the relevant proceeds of sale are, to the extent that they are not chargeable to tax under any other section of this Part and do not exceed the amount of the deduction, to be treated as a trading receipt of the trade, profession or business, arising in or derived from Hong Kong and accruing—

- (a) at the time of sale; or
- (b) if the sale occurs on or after the date on which the trade, profession or business is permanently discontinued, immediately before the discontinuance.”.

- (6) Before section 16E(4)—

Add

- “(3A) For the purposes of this section, any expenditure incurred for the purposes of a trade, profession or business by a person about to carry on the trade, profession or business is to be treated as if it had been incurred by that person on the first day on which the person carries on the trade, profession or business.”.

- (7) Section 16E(4), Chinese text, definition of **專利權**—

Repeal the semicolon

Substitute a full stop.

- (8) Section 16E(4)—

Repeal the definitions of *associate*, *associated corporation*, *beneficiary under the trust*, *control*, *principal officer* and *relative*.

- (9) Section 16E(4), after definition of *patent rights*—

Add

“***relevant proceeds of sale*** (有關售賣得益), in relation to any rights of a kind referred to in subsection (1) in respect of which a deduction has been allowed under that subsection, means—

- (a) if subsection (2) does not apply, the proceeds of sale of the rights; or
- (b) if subsection (2) applies, that part of the proceeds of sale of the rights that is proportionate to the extent to which the deduction has been allowed.”.

- (10) After section 16E(6)—

Add

- “(7) If any rights of a kind referred to in subsection (1) are purchased or sold together or with any other assets for one consideration, the Commissioner may, for the purposes of the calculation of the deduction under subsection (1) or the calculation of the trading receipt under subsection (3), and having regard to all the circumstances of the transaction, allocate a consideration for the purchase or sale of each individual asset.

- (8) For the purposes of this section, if the Commissioner is of the opinion that the consideration for the purchase or sale of any rights of a kind referred to in subsection (1) does not represent the true market value of those rights

at the time of that purchase or sale, the Commissioner may determine the true market value, and the amount so determined is to be treated—

- (a) for the purposes of subsection (1), as the expenditure incurred on purchase; and
 - (b) for the purposes of subsection (3), as the proceeds of sale, and a reference to relevant proceeds of sale is to be construed accordingly.
- (9) 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.”.

6. Sections 16EA, 16EB and 16EC added

After section 16E—

Add

“16EA. Purchase of specified intellectual property rights

- (1) Despite section 17, this section applies in ascertaining the profits from a trade, profession or business in respect of which a person is chargeable to tax under this Part for any year of assessment.
- (2) Any specified capital expenditure incurred by the person during the basis period for a year of assessment is to be deducted if the specified intellectual property right concerned is purchased for use in the trade, profession or business in the production of profits in respect of which the person is chargeable to tax under this Part.
- (3) Unless subsection (4) applies and subject to subsections (5) and (6), a deduction allowable under subsection (2) is to be deducted by 5 equal amounts—

- (a) one for the year of assessment in the basis period for which the specified capital expenditure is incurred; and
 - (b) one for each of the next succeeding 4 years of assessment.
- (4) If the specified intellectual property right—
- (a) is a copyright or registered design; and
 - (b) is due to expire at the end of its maximum period of protection, and that expiry is to occur before the expiry of the basis period for the last of the 5 succeeding years of assessment mentioned in subsection (3),
- subject to subsections (5) and (6), a deduction allowable under subsection (2) is to be deducted by a number of equal amounts—
- (c) one for the year of assessment in the basis period for which the specified capital expenditure is incurred; and
 - (d) one for each of the next succeeding years a part or the whole of the basis period of each of which years coincides with a part or the whole of the remaining part of the maximum period of protection.
- (5) A deduction mentioned in subsection (3) or (4) is allowable only if, at the end of the basis period for a year of assessment for which an amount is to be deducted, the specified intellectual property right concerned has not been sold by the person who incurred the specified capital expenditure.
- (6) A deduction mentioned in subsection (3) or (4) is allowable only if—
- (a) the specified intellectual property right concerned has been used in the trade, profession or business in

the production of profits in respect of which the person who incurred the specified capital expenditure is chargeable to tax under this Part;

- (b) (in the case of the specified intellectual property right being a copyright) the copyright subsists;
- (c) (in the case of the specified intellectual property right being a registered design) the registration of the design is in force; and
- (d) (in the case of the specified intellectual property right being a registered trade mark) the registration of the trade mark is in force,

during a part or the whole of the basis period for a year of assessment for which an amount is deducted.

- (7) If any specified intellectual property right is used partly in the production of profits chargeable to tax under this Part and partly for any other purposes, the deduction allowable under this section is that part of the specified capital expenditure that is proportionate to the extent of the use of the specified intellectual property right in the production of the profits chargeable to tax under this Part.
- (8) If any specified intellectual property rights in respect of which a deduction is allowable under this section are purchased or sold together or with any other assets for one consideration, the Commissioner may, for the purposes of the calculation of the deduction under subsection (2) or the calculation of the trading receipt under section 16EB(2), and having regard to all the circumstances of the transaction, allocate a consideration for the purchase or sale of each individual asset.
- (9) For the purposes of this section and section 16EB, if the Commissioner is of the opinion that the consideration for the purchase or sale of any specified intellectual property right does not represent the true market value of the

specified intellectual property right at the time of that purchase or sale, the Commissioner may determine the true market value, and the amount so determined is to be treated—

- (a) for the purposes of subsection (2), as the specified capital expenditure; and
- (b) for the purposes of section 16EB(2), as the proceeds of sale of the specified intellectual property right, and a reference to relevant proceeds of sale is to be construed accordingly.

- (10) For the purposes of this section, any specified capital expenditure incurred for the purposes of a trade, profession or business by a person about to carry on the trade, profession or business is to be treated as if it had been incurred by that person on the first day on which the person carries on the trade, profession or business.

- (11) In this section and sections 16EB and 16EC—

copyright (版權) means—

- (a) a copyright within the meaning of section 2(1) of the Copyright Ordinance (Cap. 528), including an unregistered corresponding design as defined by section 87(5)(b) of that Ordinance; or
- (b) any right that—
 - (i) subsists under the law of a place outside Hong Kong in any work in which a copyright referred to in paragraph (a) may subsist; and
 - (ii) corresponds to a copyright referred to in paragraph (a);

maximum period of protection (最長保護限期) means—

- (a) in the case of a specified intellectual property right that is a copyright—

- (i) (if the copyright subsists under the Copyright Ordinance (Cap. 528)) the maximum period for which the copyright may subsist under that Ordinance; or
- (ii) (if the copyright subsists under the law of a place outside Hong Kong) the maximum period for which the copyright may subsist under the law of that place;
- (b) in the case of a specified intellectual property right that is a registered design—
 - (i) (if the design is registered under the Registered Designs Ordinance (Cap. 522)) the maximum period for which the design may be registered under that Ordinance; or
 - (ii) (if the design is registered under the law of a place outside Hong Kong) the maximum period for which the design may be registered under the law of that place;

registered design (註冊外觀設計) means a design registered under section 25 of the Registered Designs Ordinance (Cap. 522) or under the law of any place outside Hong Kong;

registered trade mark (註冊商標) means a trade mark registered under section 47 of the Trade Marks Ordinance (Cap. 559) or under the law of any place outside Hong Kong;

specified capital expenditure (指明資本開支)—

- (a) means any capital expenditure incurred on the purchase of any specified intellectual property right and includes legal expenses and valuation fees incurred in connection with the purchase; but
- (b) does not include any capital expenditure that may be deducted under any other section of this Part;

specified intellectual property right (指明知識產權) means a copyright, registered design or registered trade mark.

- (12) In this section and sections 16EB and 16EC, a reference to the purchase or sale of any specified intellectual property right includes the purchase or sale of a share or interest in the specified intellectual property right.
- (13) To avoid doubt, any expenditure incurred on the acquisition of a licence (as defined by section 16EC(8)) of any specified intellectual property right is not deductible under this section.
- (14) This section applies only in ascertaining the profits in respect of which a person is chargeable to tax under Part IV of this Ordinance for the year of assessment beginning on 1 April 2011 and any subsequent year of assessment.

16EB. Proceeds of sale of specified intellectual property rights to be treated as trading receipts

- (1) This section applies despite the exclusion relating to the sale of capital assets in section 14.
- (2) Where any specified intellectual property right in respect of which a deduction has been allowed to any person under section 16EA in ascertaining the profits from a trade, profession or business is subsequently sold by the person—
 - (a) if there is an unallowed amount that exceeds the relevant proceeds of sale, the excess is to be deducted for the year of assessment in the basis period for which the sale occurs;
 - (b) if there is an unallowed amount but the relevant proceeds of sale exceed that amount, the excess is, to the extent that it is not chargeable to tax under any other section of this Part and does not exceed the amount of the deduction, to be treated as a

trading receipt of the trade, profession or business, arising in or derived from Hong Kong and accruing—

- (i) at the time of the sale; or
 - (ii) if the sale occurs on or after the date on which the trade, profession or business is permanently discontinued, immediately before the discontinuance; or
- (c) if there is not an unallowed amount, the relevant proceeds of sale are, to the extent that they are not chargeable to tax under any other section of this Part and do not exceed the amount of the deduction, to be treated as a trading receipt of the trade, profession or business, arising in or derived from Hong Kong and accruing—
- (i) at the time of the sale; or
 - (ii) if the sale occurs on or after the date on which the trade, profession or business is permanently discontinued, immediately before the discontinuance.
- (3) In this section—
- relevant proceeds of sale** (有關售賣得益), in relation to any specified intellectual property right in respect of which a deduction has been allowed under section 16EA, means—
- (a) if section 16EA(7) does not apply, the proceeds of sale of the specified intellectual property right; or
 - (b) if section 16EA(7) applies, that part of the proceeds of sale of the specified intellectual property right that is proportionate to the extent to which the deduction has been allowed;
- unallowed amount** (未獲容許扣除額), in relation to any specified intellectual property right in respect of which a

deduction has been allowed under section 16EA and which is subsequently sold, means—

- (a) if section 16EA(7) does not apply, the amount of specified capital expenditure incurred in relation to the specified intellectual property right that is still unallowed as at the time of the sale; or
- (b) if section 16EA(7) applies, that part of the amount referred to in paragraph (a) that is proportionate to the extent to which the deduction has been allowed.

16EC. Deduction under section 16E or 16EA not allowable under certain circumstances

- (1) No deduction is allowable under section 16EA in respect of any specified intellectual property right purchased by a person if—
 - (a) at any time before the commencement date, the specified intellectual property right had been used by the person under a licence the expiry date of which fell on or after the commencement date;
 - (b) the licence was terminated before that expiry date; and
 - (c) the Commissioner is of the opinion that, having regard to the early termination of the licence, the consideration for the purchase is not reasonable consideration in the circumstances of the case.
- (2) No deduction is allowable under section 16E or 16EA in respect of any relevant right purchased by a person wholly or partly from an associate.
- (3) For the purposes of subsection (2), any relevant right that is purchased or sold by a trustee of a trust estate or a corporation controlled by the trustee is deemed to have been purchased or sold by each of the trustee, the corporation and the beneficiary under the trust.

- (4) No deduction is allowable under section 16E or 16EA in respect of any relevant right purchased by a person (*taxpayer*) if at a time when the relevant right is owned by the taxpayer, a person holds rights as a licensee under a licence of the relevant right, and—
- the relevant right was, before it was purchased by the taxpayer, owned and used by that person (whether alone or with others) or any associate of that person (which person or any such associate is referred to in this section as *the end-user*);
 - the relevant right is, while the licence is in force, used wholly or principally outside Hong Kong by a person other than the taxpayer; or
 - the whole or a predominant part of the consideration for the purchase of the relevant right was financed directly or indirectly by a non-recourse debt.
- (5) Subsection (4)(a) does not apply if—
- the relevant right was purchased by the taxpayer from the end-user with a consideration not more than the consideration paid by the end-user to the supplier for purchasing the relevant right from the supplier (not being a supplier who is an end-user);
 - the purchase referred to in paragraph (a) by the end-user from the supplier occurred on or after the commencement date; and
 - no deduction under section 16E or 16EA has been allowed to the end-user in respect of the relevant right at any time before the purchase of the relevant right by the taxpayer.
- (6) For the purposes of subsection (5), a deduction is deemed not to have been made if the end-user, by notice in writing to the Commissioner within a period of 3 months beginning on the day on which the expenditure

- or specified capital expenditure is incurred in relation to the relevant right giving rise to the deduction, or within a further period that the Commissioner may in any particular case permit, disclaims the deduction.
- (7) For the purposes of subsections (4) and (5), if a trustee of a trust estate or a corporation controlled by the trustee—
- owns any relevant right; or
 - holds rights as a licensee under a licence of the relevant right,
- the trustee, the corporation and the beneficiary under the trust are each deemed to be—
- the owner of the relevant right; or
 - the holder of rights as a licensee of the relevant right
- (as the case may be).
- (8) In this section—
- associate* (相聯者), in relation to a person who purchases a relevant right or holds rights as a licensee under a licence of a relevant right (including a person who is deemed to have purchased a relevant right or deemed to be holding rights as such licensee) (*first-mentioned person*), means—
- if the first-mentioned person is a natural person—
 - any relative of the first-mentioned person;
 - any partner of the first-mentioned person;
 - if a partner of the first-mentioned person is a natural person, any relative of that partner;
 - any partnership of which the first-mentioned person is a partner;
 - any corporation controlled by—

- (A) the first-mentioned person;
- (B) a partner of the first-mentioned person;
- (C) if a partner of the first-mentioned person is a natural person, any relative of that partner; or
- (D) a partnership of which the first-mentioned person is a partner; or
- (vi) any director or principal officer of a corporation referred to in subparagraph (v);
- (b) if the first-mentioned person is a corporation—
 - (i) any associated corporation;
 - (ii) any person who controls the first-mentioned person;
 - (iii) any partner of a person who controls the first-mentioned person;
 - (iv) if a person who controls the first-mentioned person is a natural person, any relative of that person;
 - (v) if a partner referred to in subparagraph (iii) is a natural person, any relative of that partner;
 - (vi) any director or principal officer of the first-mentioned person or of any associated corporation;
 - (vii) any relative of a director or principal officer referred to in subparagraph (vi);
 - (viii) any partner of the first-mentioned person; or
 - (ix) if a partner of the first-mentioned person is a natural person, any relative of that partner; or
- (c) if the first-mentioned person is a partnership—
 - (i) any partner of the first-mentioned person;

- (ii) if a partner of the first-mentioned person is a partnership, any partner (**Partner A**) of that partnership or any partner (**Partner B**) with that partnership in any other partnership;
- (iii) if Partner A is a partnership, any partner of Partner A;
- (iv) if Partner B is a partnership, any partner of Partner B;
- (v) if a partner of, or with, or in any of the partnerships referred to in subparagraph (ii), (iii) or (iv) is a natural person, any relative of that partner;
- (vi) any corporation controlled by—
 - (A) the first-mentioned person;
 - (B) a partner of the first-mentioned person;
 - (C) if a partner of the first-mentioned person is a natural person, any relative of that partner; or
 - (D) a partnership of which the first-mentioned person is a partner;
- (vii) any director or principal officer of a corporation referred to in subparagraph (vi); or
- (viii) any corporation of which any partner of the first-mentioned person is a director or principal officer;

associated corporation (相聯法團), in relation to a person who purchases a relevant right or holds rights as a licensee under a licence of a relevant right (including a person who is deemed to have purchased a relevant right or deemed to be holding rights as such licensee) (**first-mentioned person**), means—

- (a) a corporation over which the first-mentioned person has control;
- (b) a corporation which has control over the first-mentioned person; or
- (c) a corporation which is under the control of the same person as is the first-mentioned person;

beneficiary under the trust (信託的受益人) means any person who benefits or is capable (whether by the exercise of a power of appointment or otherwise) of benefiting under a trust estate, either directly or through any interposed person, or who is able or might reasonably be expected to be able, whether directly or indirectly, to control the activities of the trust estate or the application of its corpus or income;

commencement date (生效日期) means the day on which the Inland Revenue (Amendment) (No. 2) Ordinance 2011 (of 2011) comes into operation;

control (控制), in relation to a corporation (*first-mentioned corporation*), means the power of a person to secure—

- (a) by means of the holding of shares or the possession of voting power in or in relation to the first-mentioned corporation or any other corporation; or
- (b) by virtue of any powers conferred by the articles of association or other document regulating the first-mentioned corporation or any other corporation,

that the affairs of the first-mentioned corporation are conducted in accordance with the wishes of that person;

end-user (最終使用者) means any person (whether alone or with others) holding rights as a licensee under a licence of any relevant right or any associate of the person;

licence (特許), in relation to a relevant right—

- (a) means a licence (however described and whether general or limited) authorizing the licensee to use

the relevant right in the manner authorized by the licence; but

- (b) does not include an agreement under which the ownership of the relevant right will or may be sold to or pass to the licensee unless, in the opinion of the Commissioner, the right under the agreement to purchase or obtain the ownership of the relevant right would reasonably be expected not to be exercised,

and **licensee** (特許持有人) is to be construed accordingly;

non-recourse debt (無追索權債項), in relation to the financing of the whole or a predominant part of the consideration for the purchase of any relevant right, means a debt where the rights of the creditor in the event of default in the repayment of principal or payment of interest—

- (a) are limited wholly or predominantly to any or all of the following—
 - (i) rights (including a right to moneys payable) in relation to the relevant right or the use of the relevant right;
 - (ii) rights (including a right to moneys payable) in relation to goods or services that are produced, supplied or provided using the relevant right;
 - (iii) rights (including a right to moneys payable) in relation to the loss or disposal of the whole or a part of—
 - (A) the relevant right; or
 - (B) the taxpayer's interest in the relevant right;

- (iv) any conjunction of those rights referred to in subparagraphs (i), (ii) and (iii);
- (v) rights in respect of a mortgage or other security over the relevant right;
- (vi) rights arising out of any arrangement relating to the financial obligations of the end-user of the relevant right towards the taxpayer, being financial obligations in relation to the relevant right;
- (b) are in the opinion of the Commissioner capable of being limited as described in paragraph (a), having regard to either or both of the following—
 - (i) the assets of the taxpayer;
 - (ii) any arrangement to which the taxpayer is a party; or
- (c) if paragraphs (a) and (b) do not apply, are limited by reason that not all of the assets of the taxpayer (not being assets that are security for a debt of the taxpayer other than a debt arising in relation to the financing of the whole or part of the consideration for the purchase of the relevant right) would be available for the purpose of the discharge of the whole of the debt so arising (including the payment of interest) in the event of any action or actions by the creditor or creditors against the taxpayer arising out of the debt;

principal officer (主要職員), in relation to a corporation, means—

- (a) a person employed by the corporation who, either alone or jointly with one or more other persons, is responsible under the immediate authority of the directors of the corporation for the conduct of the business of the corporation; or

- (b) a person employed by the corporation who, under the immediate authority of a director of the corporation or a person to whom paragraph (a) applies, exercises managerial functions in respect of the corporation;

relative (親屬), in relation to a person, means the spouse, parent, child, brother or sister of that person, and, in deducing such a relationship—

- (a) an adopted child is regarded as a child of both the natural parents and the adopting parents; and
- (b) a step child is regarded as a child of both the natural parents and the step parents;

relevant right (有關權利) means any patent rights (as defined by section 16E(4)), rights to any know-how (as defined by section 16E(4)) or specified intellectual property right.”.

7. Section 21A heading amended

Section 21A, English text, heading—

Repeal

“trademarks”

Substitute

“trade marks”.

8. Section 89 amended (Transitional provisions)

At the end of section 89—

Add

- “(7) Schedule 22 sets out transitional provisions that have effect for the purposes of the Inland Revenue (Amendment) (No. 2) Ordinance 2011 (of 2011).”.

9. Schedule 22 added

At the end of the Ordinance—

Add

“Schedule 22 [s. 89(7)]

**Transitional Provisions for Inland Revenue
(Amendment) (No. 2) Ordinance 2011**

1. The amendments made to section 16E(1), (2), (2A), (2B) and (4) of this Ordinance by section 5(1), (3), (4), (7) and (8) of the Inland Revenue (Amendment) (No. 2) Ordinance 2011 (of 2011) (**2011 Ordinance**) do not apply in ascertaining the profits in respect of which a person is chargeable to tax under Part IV of this Ordinance for any year of assessment preceding the year of assessment beginning on 1 April 2011.
2. Section 16E(1A), (3A) and (9) of this Ordinance applies only in ascertaining the profits in respect of which a person is chargeable to tax under Part IV of this Ordinance for the year of assessment beginning on 1 April 2011 and any subsequent year of assessment.
3. The amendments made to section 16E(3) and (4) of this Ordinance by section 5(5) and (9) of the 2011 Ordinance do not apply in respect of any rights of a kind referred to in section 16E(1) of this Ordinance—
 - (a) in respect of which a deduction has been allowed under section 16E(1) of this Ordinance to any person; and
 - (b) that are sold by the person during the basis period for any year of assessment preceding the year of assessment beginning on 1 April 2011 or are sold

by the person under a contract entered into during such a basis period.

4. Section 16E(7) and (8) of this Ordinance does not apply in respect of any rights of a kind referred to in section 16E(1) of this Ordinance that are purchased or sold during the basis period for any year of assessment preceding the year of assessment beginning on 1 April 2011 or are purchased or sold under a contract entered into during such a basis period.”.

Explanatory Memorandum

The object of this Bill is to amend the Inland Revenue Ordinance (Cap. 112) (*the Ordinance*) to provide for the deduction of capital expenditure incurred on the purchase of a copyright, registered design or registered trade mark in ascertaining the profits chargeable to tax under the Ordinance. The Bill also modifies existing provisions governing deduction of capital expenditure incurred on the purchase of patent rights or rights to any know-how.

2. Under section 16E(1) of the Ordinance, a condition for deduction of capital expenditure incurred on the purchase of patent rights or rights to any know-how is that they must be used in Hong Kong in the production of profits chargeable to tax. Clause 5(1) amends section 16E(1) of the Ordinance to remove the use in Hong Kong element.
3. Clause 5(5) amends section 16E(3) of the Ordinance to provide that if a deduction has been allowed to a person under section 16E(1) of the Ordinance in respect of patent rights or rights to any know-how, and those rights are subsequently sold by the person, the proceeds of the sale are to be treated as trading receipts only to the extent of the amount of the deduction as previously allowed.
4. Clause 5(10) mainly adds the following provisions to the Ordinance—
 - (a) a new section 16E(7) providing that if any patent rights or rights to any know-how in respect of which a deduction is allowable under section 16E(1) of the Ordinance are purchased or sold together or with any other assets for one consideration, the Commissioner of Inland Revenue (*the Commissioner*) may allocate a consideration for each individual right for the purposes of section 16E of the Ordinance;
 - (b) a new section 16E(8) providing that if the Commissioner is of the opinion that the consideration for the purchase

or sale of any patent rights or rights to any know-how does not represent the true market value of those rights, the Commissioner may determine the true market value for that purchase or sale for the purposes of section 16E of the Ordinance.

5. Clause 6 adds new sections 16EA, 16EB and 16EC to the Ordinance—
 - (a) New section 16EA provides that any capital expenditure incurred on the purchase of a copyright, registered design or registered trade mark may be deducted in ascertaining profits chargeable to profits tax (over 5 succeeding years of assessment or a lesser number of years of assessment in the case of a copyright or registered design whose maximum period of protection is due to expire before the expiry of the basis period for the last of those 5 years of assessment). That section also provides for the conditions under which and the manner in which such a deduction is to be made.
 - (b) New section 16EB provides that if a deduction has been allowed to a person under the new section 16EA in respect of a copyright, registered design or registered trade mark, and the copyright, registered design or registered trade mark is subsequently sold by the person, the proceeds of the sale are to be treated as trading receipts in the manner specified in that section.
 - (c) New section 16EC provides for the non-deduction of expenditure in various circumstances and applies to patent rights and rights to any know-how as well as copyrights, registered designs and registered trade marks. The new section 16EC incorporates section 16E(2A) and (2B) of the Ordinance (on non-deduction of expenditure for purchase of patent rights and rights to any know-how from an associate) repealed by clause 5(4).

Explanatory Memorandum

Paragraph 6

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6. Clauses 8 and 9 add a new section 89(7) and a new Schedule 22 which sets out transitional provisions.

Annex B

Copyrights

According to the Copyright Ordinance (Cap. 528), copyright is a property right which subsists in original literary, dramatic, musical or artistic works; sound recordings, films, broadcasts or cable programmes; and the typographical arrangement of published editions. Copyright is an automatic right which arises when a work is created and recorded in some way (on paper, electronically, etc). Unlike other intellectual properties such as trade marks and designs, there is no registration regime for copyright works in most of the jurisdictions including Hong Kong for the purpose of legal protection. Depending on the type of copyright works, copyright protection in Hong Kong can last for 25 years; 50 years; or the life of the author of the work plus 50 years posthumously. For unregistered corresponding design protected by the Copyright Ordinance, the protection can last for 15 years.

Registered Designs

2. Under the Registered Designs Ordinance (Cap. 522), “design” means features of shape, configuration, pattern or ornament applied to an article by any industrial process, being features which in the finished article appeal to and are judged by the eye. Like the registration regime for trade marks, the design registration system in Hong Kong runs on a territorial basis. Registration is valid for up to 25 years from the date of registration provided that it is renewed every five years.

Registered Trade Marks

3. Under the Trade Marks Ordinance (Cap. 559), a “trade mark” means any sign which is capable of distinguishing the goods or services of one undertaking from those of other undertakings and which is capable of being represented graphically. A trade mark may consist of words (including personal names), indications, designs, letters, characters, numerals, figurative elements, colours, sounds, smells, the shape of goods or their packaging and any combination of such signs.

4. Registration for trade marks in Hong Kong provides prima facie evidence of ownership of the marks. In line with international practices, the registration regime in Hong Kong runs on a territorial basis, meaning that the registration only has effect in Hong Kong and not elsewhere. Trade marks are registered for use in one or more specific classes of goods and services. Unlike copyrights and registered designs, registered trade mark rights can be perpetual provided that registration is renewed every ten years.

Financial Implications

The proposed tax deduction would have revenue implication. However, it is not possible to estimate the revenue forgone as there is no readily available information on the current amount of capital expenditure incurred by enterprises on the purchase of copyrights, registered designs and registered trade marks.

Economic Implications

The proposed tax deduction will help promote the wider application of IPRs by enterprises, encourage innovation and upgrading and facilitate development of creative industries in Hong Kong. This will be conducive to the economic development of Hong Kong.

Sustainability Implications

As far as sustainability implications are concerned, the proposed tax deduction is expected to generate positive economic benefits through wider application of IPRs by enterprises, encouraging innovation and upgrading, and facilitating development of creative industries in Hong Kong.