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6 April 2011

Miss Odelia LEUNG
Clerk to House Committee
Legislative Council Secretariat
Legislative Council Building
8 Jackson Road, Central
Hong Kong
(Fax: 2509 0775)

Dear Miss LEUNG,

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

I refer to your letter dated 1 April 2011 seeking the Administration's responses to a number of issues in relation to the Inland Revenue (Amendment) (No. 2) Bill 2011 ("the Bill") raised by the Association of Chartered Certified Accountants in Hong Kong (ACCA-HK) as relayed by Hon Paul Chan.

Background

2. The Administration introduced the Bill into the Legislative Council on 9 March 2011 with a view to giving effect to the proposal announced in the 2010-11 Budget to provide tax deduction for capital expenditure incurred on the purchase of copyrights, registered designs and registered trade marks ("specified IPRs"). The objectives are 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.

3. In order to be eligible for the proposed tax deduction, taxpayers must have acquired the "proprietary interest" of the specified IPRs and have to fulfil the registration requirement for those IPRs for which registration systems are available. Moreover, the specified IPRs have to be in use for the production of chargeable profits.

4. At present, tax deduction has already been provided for capital expenditure incurred on the purchase of patent rights and rights to any know-how on the condition that these rights are used in Hong Kong in the production of chargeable profits. Acknowledging that business activities of local enterprises are no longer confined to Hong Kong with the globalisation of the world economy, the Administration therefore proposes in the Bill to remove the "use in Hong Kong" condition currently applicable to the tax deduction for patent rights and rights to any know-how. 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. The same "relaxed" arrangement has been adopted for the proposed tax deduction for the specified IPRs.

5. Apart from the relaxation in the "use in Hong Kong" requirement, we have also proposed in the Bill to relax the "deduction claw-back rule" for patent rights and rights to any know-how by reducing the amount of sales proceeds brought to tax from full sales proceeds to not more than the deductions previously allowed. This is in line with our policy of not taxing capital gains. The above enhanced "deduction claw-back rule" has also been adopted for the proposed tax deduction for the specified IPRs.

6. As the proposed relaxations mentioned in paragraphs 4 and 5 above may be exploited to avoid profits tax, we have proposed in section 16EC of the Bill to impose some commonly-used anti-avoidance measures to prevent potential abuses.

The Administration's Response to ACCA-HK's Concerns

(a) Licensing specified IPRs for use outside Hong Kong

7. Whether royalties derived from licensing arrangements are chargeable to tax in Hong Kong depends on the facts of each case. If a Hong Kong enterprise which has purchased a relevant IPR[1] licenses that relevant IPR to another enterprise for use outside Hong Kong, its royalties (i.e. licensing fees) so derived will generally be regarded as non-Hong Kong sourced income and hence will not be subject to Hong Kong tax while no deduction will be allowed

[1] Relevant IPR means patent right, right to any know-how and specified IPR.

for its capital expenditure incurred on the purchase of the relevant IPR. Paragraph 45(g) of the Departmental Interpretation and Practice Note (DIPN) No. 21 as quoted in ACCA-HK's letter is not applicable to licensing of IPRs by taxpayers who have **purchased** the IPRs (i.e. taxpayers with proprietary interest of the IPRs).

(b) Use of IPRs outside Hong Kong under sub-contracting

8. As indicated above, section 16EC is an anti-avoidance provision to prevent possible abuse of the proposed deduction which is otherwise not available. In the case where a Hong Kong enterprise allows its overseas sub-contractor to use outside Hong Kong an IPR owned by the Hong Kong enterprise at cost, the tax treatment as described in paragraph 7 above would apply and the capital expenditure incurred on the purchase of that IPR is not deductible under section 16EC(4)(b) [2].

9. In the case where a Hong Kong enterprise allows its overseas sub-contractor to use outside Hong Kong an IPR owned by the Hong Kong enterprise at no cost, since the overseas production activities by the sub-contractor are generally not attributed to the Hong Kong enterprise, according to the "territorial source" principle, the Inland Revenue Department of Hong Kong would not charge profits tax on the sub-contractor or the Hong Kong enterprise for the overseas production activities. Accordingly, based on the "tax symmetry" principle, the Hong Kong enterprises would not be granted tax deduction for IPRs solely used in overseas production activities not carried out by the Hong Kong enterprises. This treatment is in line with our established taxation principles and our policy intent of promoting wider application of IPRs in Hong Kong. If we recognise such "no cost" arrangement for the use of IPR outside Hong Kong by granting the proposed tax deduction, overseas jurisdictions may doubt whether Hong Kong is acting in compliance with the "arm's length principle" advocated by the Organisation for Economic Cooperation and Development, thus affecting the taxing rights of the overseas jurisdictions. This is because such "no cost" arrangement would render overseas tax authorities unable to tax on the Hong Kong enterprise's royalties income. Also, such "no cost" arrangement would render the sub-contractor charge lower price for goods sold to the Hong Kong enterprise, thus reducing the level of chargeable profits in that overseas jurisdiction. We consider that Hong Kong should not act in a way that would undermine the taxing rights of other jurisdictions by recognizing such "no cost" arrangement through the granting of the proposed tax deduction, otherwise Hong Kong may be labeled as a harmful tax competitor internationally.

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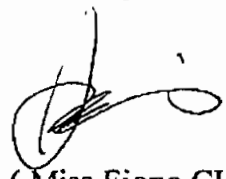
[2] The proposed new section 16EC(4)(b) would deny the proposed tax deduction of capital expenditure incurred on the purchase of patent rights, rights to any know-how and specified IPRs if the afore-mentioned IPRs are used wholly or principally outside Hong Kong by a person other than the taxpayer.

(c) *Use of IPRs by another person other than the taxpayer who incurs the expenditure*

10. The word "use" should be accorded its ordinary meaning. Based on the example given in ACCA-HK's letter, if a taxpayer grants a licence to another person (the licensee) to use in Hong Kong the relevant IPR purchased by the taxpayer, such relevant IPR would be considered as being "used" by the taxpayer in Hong Kong. Provided that the relevant IPR is used for the production of the taxpayer's chargeable profits under the Inland Revenue Ordinance and that the capital expenditure to acquire the relevant IPR is not prohibited for deduction under the proposed new section 16EC, the taxpayer is eligible to claim tax deduction under the existing section 16E or the proposed new section 16EA for the capital expenditure incurred on the purchase of the relevant IPR.

Yours sincerely,



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

c.c. CIR (Attn: Ms Judy YIP, SA)
DoJ (Attn: Miss Betty CHEUNG, SALD)
DoJ (Attn: Mr MY CHEUNG, ALO)