立法會
Legislative Council

LC Paper No. CB(1)432/11-12

Ref: CB1/BC/4/10

Paper for the House Committee meeting on 25 November 2011

Report of the
Bills Committee on Inland Revenue (Amendment) (No. 2) Bill 2011

Purpose

This paper reports on the deliberations of the Bills Committee on Inland Revenue (Amendment) (No. 2) Bill 2011 ("the Bill").

Background

2. At present, under section 16(1)(g) of the Inland Revenue Ordinance (Cap. 112) ("IRO"), enterprises may claim tax deduction on expenditure related to the registration of trade marks, designs or patents that are used for producing taxable profits. Besides, section 16E[1] provides that capital expenditure on the purchase of patent rights or rights to any know-how is tax deductible. To promote wider application of intellectual property rights ("IPRs") by enterprises and the development of creative industries, the Financial Secretary proposed in the 2010–2011 Budget that the profits tax deduction be extended to cover capital expenditure for purchase of three types of IPRs, namely, registered trade marks, copyrights and registered designs.

The Bill

3. The Bill was gazetted on 25 February 2011 and introduced into the Legislative Council on 9 March 2011. The objects of the Bill are as follows -

[1] To avoid repetition, unless otherwise specified, all the legislative provisions referred to in this report are provisions in IRO.

(a) to amend IRO to provide for the deduction, in ascertaining profits chargeable to tax under IRO, of capital expenditure incurred on the purchase of a copyright, registered design or registered trade mark;

(b) to modify the provisions of IRO governing deduction, in ascertaining profits chargeable to tax under the Ordinance, of capital expenditure incurred on the purchase of patent rights and rights to any know-how; and

(c) to provide for incidental matters.

The major proposals in the Bill are set out in paragraphs 4, 5 and 6 below.

Copyrights, registered designs and registered trade marks

4. Clause 6 of the Bill proposes to add new sections to IRO to provide profits tax deduction for capital expenditure incurred on the purchase of copyrights, registered designs and registered trade marks ("the specified IPRs"). The major proposals include the following -

(a) it is a condition for eligibility for deduction that IPRs for which registration systems are available (namely trade marks and designs but not copyrights) are registered, as reflected in the definition of “specified IPR”;

(b) other conditions for the tax deduction include (i) taxpayers must have acquired the "proprietary interest" of the specified IPRs; (ii) the specified IPRs must be in use for the production of chargeable profits; and (iii) where a specified IPR is used partly in the production of chargeable profits, deduction is only allowed for the part of capital expenditure that is proportionate to the extent of the use of the specified IPRs in the production of such profits; and

(c) tax deduction for the specified IPRs is to be spread over five succeeding years of assessment on a straight-line basis commencing from the year of purchase; where a specified IPR, being a copyright or registered design, reaches the end of its maximum period of protection within the five-year deduction period, the deduction is to be spread in equal amounts over the number of years of assessment during which the whole or part of the basis period for the year of assessment the protection of the specified IPR subsists.

Patent rights and rights to any know-how

5. The Administration also takes the opportunity to review the relevant provisions on the current tax deduction in respect of the purchase of patent rights and rights to any know-how. The Bill includes the following major proposals -

(a) 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 IRO*;*

(b) in line with the Government's policy of not taxing capital gains, to cap the sales proceeds for patent rights and rights to any know-how to be brought to tax at deductions previously allowed; and

(c) to spell out the arrangement that 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 IRO.

The above proposed arrangements will also be applicable to the specified IPRs.

Anti-avoidance Provisions

6. The Bill proposes to add the following new provisions, containing measures commonly used for other tax deduction items, to guard against possible tax avoidance -

(a) proposed section 16EC(1) provides that a deduction will not be allowed if a specified IPR has been in use by a taxpayer under a licence before the proposed scheme commences operation, and the taxpayer terminates the licence before its expiry and purchases the specified IPRs at unreasonable consideration;

(b) proposed section 16EC(2) states that deductions will not be allowed for patent rights, rights to any know-how or the specified IPRs (“any of the five IPRs”) purchased wholly or partly from an associate;

(c) proposed section 16EC(4) to (7) provides that deduction will not be allowed for the purchase of any of the five IPRs under "sale and licence back" and "leveraged licensing" arrangements with an

escape provision so that normal business activities would not be affected; and

(d) proposed sections 16E(8) and 16EA(9) empower the Commissioner of Inland Revenue ("Commissioner") to determine, where the circumstances so warrant, the true market value for any purchase or sale of any of the five IPRs in respect of which a tax deduction is claimed. The deduction allowable should be restricted to the true market price so determined. Where any of the five IPRs are purchased or sold together or with any other assets for a single consideration, proposed sections 16E(7) and 16EA(8) confer power on the Commissioner to allocate a consideration for each individual asset as purchased or sold having regard to all the circumstances of the transaction.

The Bills Committee

7. At the House Committee meeting on 8 April 2011, Members agreed to form a Bills Committee to study the Bill. Under the chairmanship of Hon Paul CHAN Mo-po, the Bills Committee has held seven meetings. The membership list of the Bills Committee is at **Appendix I**. The public including relevant trade associations and professional organizations have been invited to give views on the Bill. The Bills Committee received oral representations from three deputations at the meeting on 28 May 2011 and received written submissions from 10 other organizations. A list of the organizations which have submitted views to the Bills Committee is at **Appendix II**.

Deliberations of the Bills Committee

8. The main issues deliberated by the Bills Committee include the scope of specified IPRs covered by the proposed tax deduction, conditions for the proposed tax deduction, power of the Commissioner to determine true market value of any of the five IPRs, scope and application of the proposed anti-avoidance provisions, and tax deduction arrangements for any of the five IPRs involved in cross-border activities. The ensuing part of the report summarizes the Bills Committee's deliberations.

Scope of specified IPRs covered by the proposed tax deduction

9. Hon Mrs Regina IP has opined that to facilitate the development of a knowledge-based economy in Hong Kong, the proposed tax deduction should apply to more types of IPRs. In this regard, she has suggested that reference be made to the scope of IPRs covered by the Convention Establishing the World Intellectual Property Organization.[2] The Bills Committee notes that some deputations[3] have also expressed the view that the proposed scope of tax deduction is not wide enough.

10. The Administration has responded that the three specified IPRs were chosen because they are commonly used in various industries and are conducive to innovation and upgrading of enterprises in different sectors. This is in line with the "tax neutrality" principle adopted in Hong Kong. However, if in future the extension of the tax deduction to other types of IPRs could be justified on policy grounds, the Administration would be prepared to consider the merits of the case.

11. According to the information provided by the Administration, tax deduction is provided with respect to capital expenditure incurred on the five IPRs of patents, know-how, copyright, registered designs and registered trade marks in Canada, Singapore and the United Kingdom ("the UK"). In Australia, capital allowance deduction is provided for patents, copyright and registered designs, but not trade marks.

12. Taking into consideration that the objective of the proposed tax deduction is to promote the wider application of IPRs, the Bills Committee has requested the Administration to relay to the Financial Secretary for future consideration outside the context of the Bill the suggestion of extending the proposed tax deduction scheme to more types of IPRs. The Bills Committee has also agreed to refer the issue to the Panel on Commerce and Industry for follow-up as appropriate.

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[2] The Convention Establishing the World Intellectual Property Organization is the constituent instrument of the World Intellectual Property Organization ("WIPO"), and was signed at Stockholm on July 14, 1967, entered into force in 1970 and amended in 1979. WIPO is an intergovernmental organization that became in 1974 one of the specialized agencies of the United Nations system of organizations.

[3] Hong Kong Institute of Certified Public Accountants ("HKICPA") and the Joint Liaison Committee on Taxation ("JLCT").

Conditions for the proposed tax deduction

Registration Requirement

13. For the purpose of granting the proposed tax deduction, the Bill imposes a registration condition for those specified IPRs for which registration systems are available, namely trade marks and designs but not copyrights.[4] As provided for in the Bill, registration in either Hong Kong or overseas would meet the condition.

14. Some deputations[5] have pointed out that it may take some time for the relevant registration authorities to complete processing of taxpayers' applications for registering the assignments of registered trade marks or registered designs purchased by them and for registering themselves as the registered owners. The deputations have expressed concern on (a) whether and when tax deduction would be granted if the registration of assignment of a registered IPR is still being processed at the end of the assessment year in which capital expenditure for the purchase of the IPR is incurred; and (b) what measures would be taken if the registration of an IPR is invalidated, revoked or surrendered after tax deduction has been granted.

15. The Administration has clarified that, for the purpose of granting tax deduction as proposed by the amended section 16E and proposed new section 16EA, the Inland Revenue Department ("IRD") has to ascertain that the taxpayers have fulfilled the following requirements -

(a) the taxpayers have purchased the IPRs covered by the Bill, and for the IPRs where registration systems are available (i.e. patents, trade marks or designs), the registrations of these IPRs concerned must be in force; and

(b) the IPRs mentioned in (a) above have been used by the taxpayers for production of profits chargeable to tax in Hong Kong.

16. The Administration has further advised that for the purpose of ascertaining that the taxpayers have fulfilled the requirement of purchasing IPRs which have been registered as stated in paragraph 15(a) above, IRD would accept documentary evidence provided by the taxpayers to support that the IPRs purchased by them are registered ones. According to the Intellectual Property

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[4] 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.

[5] HKICPA, JLCT and the Federation of Hong Kong Industries ("FHKI")

Department, in order to protect their rights in the patents, registered trade marks or registered designs purchased, it would be common for taxpayers, where applicable, to submit applications to the relevant registration authorities for registering the assignments of the relevant IPRs such that their names would appear as the registered owners on the relevant registers. If the taxpayers could demonstrate to IRD that they have applied for registration of assignment of the relevant registered IPRs, this would assist in clearly establishing that they have purchased the relevant IPRs.

17. The Administration has also explained that if the taxpayers' applications for registering the assignments of the relevant IPRs are rejected eventually, this will cause IRD to have reasonable doubt on whether the taxpayers have in fact purchased the IPRs concerned, and IRD would hence conduct further investigation. Nevertheless, if the taxpayers are able to provide other documentary proof to the satisfaction of IRD that they have purchased the registered IPRs, IRD would not claw back the tax deduction previously provided to the taxpayers. If the registration of an IPR is invalidated, revoked or surrendered, the IPR will not be eligible for the proposed tax deduction under the Bill. Additional assessment will be made as appropriate to clawback any tax deduction previously allowed by virtue of existing section 60 of IRO.

18. As regards the requirement of "use" set out in paragraph 15(b) above, the Administration has advised that it will implement the requirement taking into account the intangible nature of the IPRs; if taxpayers can prove to the satisfaction of IRD that they have carried out concrete steps in relation to the use of the IPRs for production of chargeable profits, IRD may accept that the taxpayers have fulfilled the requirement of "use" stipulated in the Bill. IRD would, having regard to the relevant facts of individual cases, determine if the taxpayers concerned have "used" the purchased IPRs for production of chargeable profits.

19. At the Bills Committee's request, the Administration has agreed to set out in the Departmental Interpretation and Practice Notes ("DIPNs") of IRD the arrangements regarding the tax deduction for the purchase of IPRs the registration of assignment of which is still being processed and the clawback arrangements for invalidated/revoked/surrendered IPR registrations.

Requirement of having acquired the proprietary interest of the IPRs

20. Apart from the registration requirement, the Bill provides that a taxpayer should fulfil the following conditions in order to be eligible for the proposed tax deduction –

(a) the taxpayers must have acquired the "proprietary interest" of the IPR concerned;

(b) the IPR is in use for the production of chargeable profits; and

(c) where the IPR is used partly in the production of chargeable profits, deduction is only allowed for the part of capital expenditure that is proportionate to the extent of the use of the IPR in the production of such chargeable profits.

21. The Bills Committee has asked about the meaning and rationale for the "proprietary interest" requirement. The Administration has advised that under the existing IRO, the requirement for acquisition of proprietary ownership applies to the existing items of tax deductible capital expenditure including patent rights or rights to any know-how. The relevant statutory registries which keep registers of designs and trade marks registered under the statutory regime [i.e. the Registered Designs Ordinance (Cap. 522) and the Trade Marks Ordinance (Cap. 559)] serves as prima facie evidence of "proprietary ownership". As for copyrights for which a registration system is not available, the Copyright Ordinance (Cap. 528) governs the determination of copyright ownership.

22. In this connection, the Bills Committee has enquired about the relevant tax deduction arrangement under the scenario that a taxpayer has paid an upfront fee in obtaining a licence from the owner of a specified IPR for use of the specified IPR over a specified period of time, and has agreed to pay annual licensing fees over the specified period.

23. The Administration has advised that under the licensing arrangement, the taxpayer has not acquired the ownership of the specified IPR. Hence, under the Bill, the taxpayer will not be eligible to claim tax deduction under proposed section 16EA for the payment (including both the upfront fee and the annual licensing fee) made for the IPR licence. The Administration has also advised that a very important feature of Hong Kong's taxation system is that no tax is levied on capital receipts and by symmetry no tax deduction is allowed for capital expenditure. The existing section 17(1)(c) specifically disallows the deduction of any expenditure of a capital nature unless it is otherwise explicitly stated in other sections of IRO[6], whereas the existing section 14(1) excludes any capital receipts as assessable profits. Since the upfront fee of an IPR licence is

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[6] 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.

capital in nature[7], under the existing IRO, it is not deductible and the corresponding upfront payment earned by the licensor is not taxable either. However, under the existing section 16, 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 deductible under the existing IRO.

24. The Chairman and Hon James TO have pointed out that the arrangement of paying an upfront licensing fee for acquisition of the right to use an IPR is common in a knowledge-based economy such as Hong Kong, as owners of high quality IPRs are often reluctant to sell their IPRs and are only willing to license them by charging an upfront licence fee. Since the policy objective of the proposed tax deduction is to promote the wider application of IPRs, the Chairman and Hon James TO have asked the Administration to consider the feasibility of extending the proposed tax deduction to cover such upfront licensing fees.

25. The Administration has responded that since Hong Kong does not tax the corresponding capital receipts of licensors (for both local and overseas), Hong Kong would suffer revenue loss if tax deduction is extended to cover upfront licence fees. The Government needs to maintain the "tax symmetry" principle to avoid revenue loss. The Administration has stressed that the policy intent of the Bill is to provide tax deduction for capital expenditure on "purchase" but not licensing of the specified IPRs. Such policy intent has been clearly reflected in the long title of the Bill and in proposed sections 16E(9) and 16EA(13) which explicitly stipulate that any expenditure incurred on the acquisition of a licence of an IPR is not deductible.

26. As regards the relevant arrangement in other jurisdictions, the Administration has advised that in considering how certain tax deductions should be granted, all jurisdictions uphold the principle of "tax symmetry" in order to avoid revenue loss and potential abuses. In Singapore, where capital gains tax is not levied, the taxpayers are required to have the legal and economic ownership of the IPRs concerned for claiming the tax deduction. While in Australia, Canada and the UK a similar requirement is not imposed on the taxpayers, capital gains tax is levied in these jurisdictions, and therefore the principle of "tax symmetry" could be upheld even though the licensing fees paid in a lump sum by the licensees are treated as deductible capital expenditure because the licensing fees so received by the licensors are taxable capital receipts.

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[7] As advised by the Administration, according to case law, expenditure would be capital in nature for taxation purpose if the expenditure as incurred is to secure benefits for a business that are enduring in nature.

Apportionment

27. With regard to the principle stated in paragraph 20(c) above, some members including Hon Audrey EU and Hon WONG Ting-kwong have expressed concern that the apportionment computation could be very complex, and enquired whether other jurisdictions adopted similar arrangements. The Administration has advised that such apportionment computation is not needed for tax assessment in many other jurisdictions because, unlike Hong Kong, they raise tax on a global basis rather than adopting the "territorial source" principle in their tax regimes. For Hong Kong, the apportionment computation is necessary in order to prevent revenue loss by limiting deductions to the part of capital expenditure incurred in purchasing the IPRs that is proportionate to the extent of the use of the IPRs in the production of chargeable profits.

28. Hon WONG Ting-kwong has requested the Administration to consider specifying a formula for the apportionment computation, to facilitate the trades' understanding of the apportionment arrangement. The Administration has responded that the basic principle and general rules for apportionment are set out in the existing section 16(1) of IRO and the Inland Revenue Rules (Cap. 112 sub. leg. A) respectively. It is not feasible to stipulate a formula for apportionment for application to all possible scenarios, given the great variety of business modes of the trades. Nevertheless, the Administration would consider enhancing the dissemination of relevant information to the trades with regard to the basic principles and rationale for apportionment.

Power of Commissioner to determine true market value of IPRs

29. The Bills Committee notes that under proposed sections 16E(8) and 16EA(9), the Commissioner is empowered to determine the true market price for any sale or purchase transactions of the IPRs for tax deduction purpose.

30. The Chairman and some members including Ir Hon Dr Raymond HO, Hon Miriam LAU and Hon Mrs Regina IP have expressed concern as to how the Administration would ensure that the Commissioner would make such determination in an objective manner and whether a mechanism is available for taxpayers to appeal against the Commissioner's determination. The Bills Committee also notes the view of a deputation[8] that there is no need to provide the Commissioner with such power as the general anti-avoidance provision in section 61A can be invoked to deal with cases where IPR transactions between unassociated entities are motivated by tax avoidance.

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[8] HKICPA

31. The Administration has advised that the power of the Commissioner to determine true market value of an asset for tax purpose is not new under IRO.[9] Tax deduction for capital expenditure on the purchase of IPRs is prone to abuse. To combat price manipulation, the Commissioner should be empowered to determine the true market price for any sale or purchase transactions of the IPRs. The tax deduction allowable should be restricted to the true market price so adjusted. The tax authorities of comparable jurisdictions are all empowered to determine for tax deduction purpose the true market value of the IPRs. In claiming the proposed tax deduction, taxpayers will not be required to file the valuation reports on the IPRs concerned together with their tax returns. However, when making tax assessments, IRD may, as it deems necessary, request taxpayers to provide documentary proofs such as valuation reports to substantiate the purchase prices of the IPRs concerned. For warranted cases, IRD may also seek advice from independent professional valuating organizations on the true market value of the IPRs concerned.[10]

32. In view of the Bills Committee's concern, the Administration has undertaken that apart from specifying the arrangements for determining for tax purpose the true market value of an IPR in the DIPNs of IRD, the relevant arrangements would be mentioned in the speech of the public officer in charge during the resumption of the Second Reading debate on the Bill.

33. Regarding appeal arrangements, the Administration has advised that a statutory objection and appeal mechanism is already provided under the existing IRO, and there is no need to make additional provisions about the appeal arrangement in the Bill. Under the existing statutory appeal mechanism, a taxpayer can raise objection with the Commissioner; and if the taxpayer is still dissatisfied with the Commissioner's determination, he can lodge an appeal to the Board of Review and further to the Courts.

34. Noting that the terms "true value" and "true market value" are used in the existing IRO and the Administration's advice that the two terms have the same meaning for the purposes of IRO, Hon Audrey EU has suggested that the Administration consider using the same term, i.e. either "true value" or "true market value", in IRO to eliminate potential ambiguity. The Administration has confirmed that the term "true market value" is consistently used in the relevant existing provisions, i.e. section 16G (on prescribed fixed asset),

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[9] 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 IRO.

[10] The Administration has advised that IRD would need to seek the advice of independent professional valuers owing to the lack of in-house expertise in this specialized field.

section 16J (on environmental protection facilities) and section 38B (on commercial, industrial buildings, machinery and plant), of IRO 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 Bill.

Anti-avoidance provisions

Rent and buy situations

35. In order to deter taxpayers from purchasing the specified IPRs that have already been used by them under a licence solely for tax benefits when the proposed scheme is introduced, proposed section 16EC(1) disallows the granting of the proposed tax deduction for specified IPRs to a taxpayer who, on or after the commencement date of the Bill, has purchased a specified IPR which he/she has been using under a licence before the commencement date of the Bill if -

(a) the expiry date of the licence fell on or after the commencement date of the Bill;

(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.

36. The Bills Committee has noted the views of some deputations[11] that proposed section 16EC(1) is too broad in scope and the abuses that this provision seeks to deal with can be addressed by the existing section 61A.

37. The Administration has explained that proposed section 16EC(1) is a transitional anti-avoidance provision which aims to prevent the licensor and the licensee of a specified IPR from abusing the proposed tax deduction, by turning the licensing arrangement into a sale and purchase arrangement with an unreasonably "low" purchase consideration which may be bundled with an option to buy back the specified IPR on a later day. By doing so, the licensor

[11] JLCT and HKICPA.

would enjoy the benefits of turning the taxable income (i.e. the original royalties) into non-taxable capital receipt, whereas the licensee enjoys the benefit of accelerated deduction (5-year straight-line deduction vis-à-vis annual deduction over the whole licensing period). Nevertheless, this transitional anti-avoidance measure would not be applicable to a genuine transaction where the purchase price of a specified IPR is, in the view of the Commissioner, reasonable consideration for acquiring the proprietary interest of the specified IPR.

38. As regards the necessity of proposed section 16EC(1), the Administration has advised that the existing section 61A is only a general anti-avoidance provision and is not aimed at tackling a specific transaction or arrangement. Proposed section 16EC(1), on the other hand, focuses on a specific tax avoidance arrangement and therefore would be more effective in combating such arrangement and could help avoid unnecessary disputes.

39. At the Bills Committee's request, the Administration has agreed to set out in DIPNs the factors to be considered by the Commissioner in making his determination under proposed section 16EC(1)(c).

40. Hon Miriam LAU has observed that given the current drafting of proposed section 16EC(1)(b), the provision may only catch a "tax avoidance" transaction where there is an explicit arrangement to terminate the licence before the expiry of the licence. Noting the Administration's advice that the policy intent is that such an explicit arrangement to terminate the licence is not a necessary condition for the application of the anti-avoidance provision, the Bills Committee has requested the Administration to consider refining the provision to reflect the policy intent.

41. The Administration has responded that if an 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). 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, proposed section 16EC(1)(b) would be met as the licence has been 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 proposed section 16EC(1)(b) reflects the policy intent and would not pose a hurdle to IRD in invoking the anti-avoidance provision.

Transactions between associates

42. Proposed section 16EC(2) states that deductions will not be allowed for patent rights, rights to any know-how or the specified IPRs purchased wholly or

partly from an associate. The definition of "associate" is contained in proposed section 16EC(8), which is modelled upon the definition of the same expression that applies to the current tax deduction regime on patent rights and rights to know-how under the existing section 16E(4).

43. Mr James TO has queried the approach adopted for the anti-avoidance measure, as it would result in blanket denial of tax deduction for IPR transactions between associates. He considers that so long as the transaction price is fair and reasonable, the expenditure incurred on the purchase of an IPR should be able to enjoy the proposed tax deduction. The Administration should therefore focus on ensuring that the proposed legislation would be sufficient to enable the tax authority to determine whether a transaction between two associates was made at arm's length, and hence the consideration involved does not exceed a fair market value.

44. The Administration has responded that the same anti-avoidance measure in respect of patent rights and rights to any know-how has been put in place since 1992, as abusive use of the tax deduction by associated companies was found. Associated companies could easily manipulate the transaction price of the IPRs for tax avoidance purpose. Moreover, as the market value of the IPRs may appreciate and it is now proposed under the Bill to cap the sales proceeds of the IPRs to be brought to tax at deductions previously allowed, there will be incentive for one member company of a group to transfer the IPRs to another member company for tax avoidance purposes. Accordingly, the Administration considers it necessary to adopt the anti-avoidance measure provided under proposed section 16EC(2). While some comparable jurisdictions (such as Australia and Canada) allow tax deduction for IPRs transferred among associates, it should be noted that there is little incentive for the associated companies to make abusive use of the tax deduction in those jurisdictions, as such jurisdictions levy capital gains tax and the full proceeds arising from the sale of the IPRs would be brought to tax.

45. The Bills Committee notes the view of some deputations[12] that IPR transactions arising from mergers and acquisitions ("M&A") should not be caught by proposed section 16EC(2) or any other anti-avoidance provisions. The deputations have pointed out that the transfer of ownership of IPRs registered in various jurisdictions often involves complicated and lengthy legal procedures. In order to avoid any delay in the M&A process, the transfer of ownership of IPRs is often carried out after the merger or acquisition. By that time, as the companies concerned would become associates, the company

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[12] The Chinese Manufacturers' Association of Hong Kong ("CMAHK") and PricewaterhouseCoopers Ltd ("PWC").

purchasing the IPRs would be denied the proposed tax deduction for the capital expenditure on the purchase of the IPRs.

46. Taking note of the deputations' concern, the Bills Committee has requested the Administration to consider formulating an escape clause under the anti-avoidance provision on "associates" to cater for the purchase of IPRs under normal M&A transactions.

47. The Administration has responded that it has made reference to the relevant pieces of legislation of comparable overseas jurisdictions, and found that those pieces of legislation do not contain any escape clause to cater for normal M&A transactions. The Administration also does not see any valid justifications to exclude IPR transactions under M&As from the anti-avoidance provision on "associates". The Administration has further pointed out that for M&As where huge sums of money are at stake, the parties concerned will normally seek professional advice from lawyers and accountants in order to ensure that such transactions are tax-efficient, for instance, to arrange separate agreements to purchase the IPRs before the parties become associates after M&As. As such, the absence of the suggested escape clause would not pose significant impact on the parties concerned.

48. Hon Miriam LAU and Hon Abraham SHEK have observed that the definition of the term "associate" varies under different pieces of legislation, and expressed concern whether the differences, especially in the scope of persons covered, are justified.

49. The Administration has advised that among the seven pieces of legislation administered by IRD, there are eight provisions in IRO and one provision in the Betting Duty Ordinance (Cap. 108) ("BDO") which carry definitions of "associate". By and large, the eight definitions of "associate" in the existing sections 9A, 14A, 16, 16E, 20AA, 20AE, 21A and 39E of IRO are similar. They are embodied into different specific anti-avoidance provisions of IRO. As each specific anti-avoidance provision targets at different tax avoidance arrangements in different contexts, if circumstances so warrant, the definition of "associate" may need to be adjusted suitably in order to be more focused and effective in preventing the targeted tax avoidance arrangement. The definition of "associate" in BDO is used specifically for the betting duty regime and is therefore not comparable to the definitions of "associate" in IRO.

Use of IPRs in cross-border activities

50. The Bills Committee notes that a number of deputations[13] have raised concern over or objection to proposed section 16EC(4)(b), under which no deduction is allowable if the relevant IPR is used wholly or principally outside Hong Kong by a person other than the taxpayer under a licensing arrangement. In gist, the deputations consider that proposed section 16EC(4)(b) would have undesired side effects that would hinder many normal business operations particularly cross-border processing activities, as in the case of section 39E(1)(b)(i) of the existing IRO[14] (on which proposed section 16EC(4)(b) is modelled). The deputations also consider that proposed section 16EC(4)(b) is not needed, as proposed section 16EA(2) already serves to reflect the policy intent of denying tax deduction in respect of IPRs not used for the production of profits chargeable to tax in Hong Kong. Besides, IRD can tackle tax avoidance by way of the general anti-avoidance measures provided under the existing sections 61 and 61A.

51. The Administration has responded that the policy intent of granting tax deduction for IPRs only when the IPRs are used for producing chargeable profits in Hong Kong has been made very clear by way of the existing section 16E(1) and proposed section 16EA(2). In line with the policy intent, proposed section 16EC(4)(b) serves to put beyond doubt that the IPRs used outside Hong Kong by another party would not be eligible for tax deduction in Hong Kong as such IPRs are not used for production of profits chargeable to tax in Hong Kong. Deleting proposed section 16EC(4)(b) will create uncertainty which may lead to disputes over the locality of profits in cross-border manufacturing activities. Moreover, if the Government were to provide tax deduction for IPRs used outside Hong Kong by the taxpayers' associates on a rent-free basis for production of finished products which would be sold to the taxpayers at a price below normal price, Hong Kong may be perceived by other tax jurisdictions as encouraging transfer pricing as the above arrangements could be regarded as "offsetting transactions".

52. In connection with the use of IPRs in cross-border activities, the Administration has advised that proposed section 16EC(4)(b) does not apply to

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[13] Association of Chartered Certified Accountants, HKCMA, HKICPA, JLCT and PWC

[14] Section 39E(1)(b)(i) provides that a taxpayer providing machinery or plant to another person for use wholly or principally outside Hong Kong under a licensing arrangement is not eligible to claim depreciation allowance for tax assessment in Hong Kong. According to the Administration's interpretation of the provision, section 39E(1)(b)(i) will apply when Hong Kong enterprises make their machinery or plants available for use by Mainland enterprises free of charge under the import processing arrangement.

the "contract processing" arrangement[15]. Based on the "territorial source" and "tax symmetry" principles, the Government allows a 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, the Government allows 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 IPRs and the Hong Kong registered IPRs.

53. In its second submission to the Bills Committee, HKICPA expresses the view that the Administration's argument that deletion of proposed section 16EC(4)(b) may lead to disputes over the locality of profits in cross-border manufacturing activities is problematic, as the principles for determining the source of profits are well established and there has been a good deal of case law on this subject. JLCT in its second submission opines that a Hong Kong IPR owner allowing its contract manufacturer to use the relevant IPR outside Hong Kong for the manufacturing of goods ordered by the owner is generally for the purpose of the owner generating its own profits derived from the trading of goods supplied by the contract manufacturer. So long as the trading profits of the owner are chargeable to tax in Hong Kong, there is no policy consideration justifying the denial of the tax deduction for the purchase costs incurred by the owner on the relevant IPR. JLCT also disagrees with the Administration's view that 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 the Hong Kong enterprise at a price below normal price, such arrangement would constitute an offsetting transaction.

54. In response, the Administration maintains its position regarding the necessity of 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. Regarding the issue of offsetting transactions arising from cross-border activities, the Administration has advised that it has obtained confirmation from the State Administration of Taxation ("SAT") that the arrangement cited by JLCT may constitute an offsetting transaction under

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[15] As advised by the Administration, under the "contract processing" arrangement, the Hong Kong enterprise concerned is responsible for supplying all necessary raw materials and production equipment including the Mainland registered IPRs 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.

the "Implementation Measures of Special Tax Adjustments (Provisional)" (Guoshuifa [2009] No. 2) of the Mainland.

55. Having regard to the views of deputations and the Administration's response, the Chairman and some members including Hon Miriam LAU, Ir Hon Dr Raymond HO, Hon Audrey EU and Hon WONG Ting-kwong have expressed concern that enactment of proposed section 16EC(4)(b) may affect normal business operations, particularly the common arrangement of Hong Kong enterprises to sub-contract Mainland manufacturers to produce goods on their behalf using the IPRs they have purchased in the manufacturing process. The members note that under the sub-contracting arrangement, the Mainland entity is not granted an "open-end" licence to use the IPR and the manufactured products would only be sold to the Hong Kong enterprise concerned. As the Mainland manufacturer would not sell the manufactured products to a third party for profits, the Hong Kong enterprise usually would not charge the Mainland entity a licensee fee for the use of the IPR in the manufacturing process.

56. In response to the members' concern, the Administration has made the following points:

(a) The proposed measures in the Bill are more favourable to taxpayers than the arrangements under the existing legislation as the Bill proposed to remove the "use in Hong Kong" condition and tax deduction would be granted for the relevant IPRs irrespective of whether they are used in Hong Kong so long as they are used by the taxpayers themselves for production of profits chargeable to tax in Hong Kong.

(b) When the Hong Kong enterprise, which has purchased the IPR concerned and contracted a Mainland manufacturer to produce goods using the IPR in the manufacturing process, sells the manufactured goods and earns profits chargeable to tax in Hong Kong, it can enjoy the proposed tax deduction for the part of the capital expenditure incurred on the purchase of the IPR used in the enterprise's trading activities.

(c) Regarding the issue of offsetting transactions arising from cross-border activities, SAT has confirmed that the royalty-free IPR licensing arrangement involved in the Mainland sub-contracting arrangement as cited by JLCT and members would be regarded as an offsetting transaction because the IPR concerned is used in the

> Mainland manufacturing process and the taxing rights of the Mainland are adversely affected. Apart from SAT, the international community also consider the activity to be an offsetting transaction violating the "arm's length" principle.

57. Notwithstanding the Administration's advice above, the Bills Committee considered that the Administration had not fully addressed members' concern that enactment of proposed section 16EC(4)(b) would result in blanket denial of the proposed tax deduction for cross-border activities involving the use of IPRs by a party other than the taxpayer, and hence would affect the efficacy of the Bill in achieving the objective of promoting application of IPRs in Hong Kong. The Bills Committee therefore has requested the Administration to review its position, taking into account the peculiar mode of operation of Hong Kong enterprises. In this connection, Hon Audrey EU has suggested adding an exemption clause to proposed section 16EC(4)(b) such that the anti-avoidance provision would not apply to the situation where the contract manufacturer is granted the relevant IPR only for the production of goods ordered by the owner of the IPR. The Bills Committee has also requested the Administration to provide its correspondence with SAT on the issue of offsetting transactions involved in cross-border activities to facilitate the members' further consideration of the issue.

58. The Administration has subsequently provided further information with examples to clarify the tax deduction arrangements, particularly with regard to the application or otherwise of proposed section 16EC(4)(b), in different scenarios involving cross-border activities. The Administration has highlighted that given the unique territorial nature of the registration system and protection of the IPRs covered in the Bill (i.e. the territorial scope of protection of an IPR registered in a jurisdiction is solely restricted to that jurisdiction), the tax deduction proposed by the Bill is applicable to IPRs used by Hong Kong companies in cross-border activities. The Administration has re-affirmed that proposed section 16EC(4)(b) is in line with the policy intent to allow tax deduction in respect of any IPRs used for the production of profits chargeable to tax in Hong Kong. Proposed section 16EC(4)(b) is essential given the established taxation principles of "territorial source" and "tax symmetry" and the need to avoid tax loss. For the same reasons, the Administration could not amend proposed section 16EC(4)(b) in response to Hon Audrey EU's proposal to include an exemption clause (i.e. an amendment to the effect that if the relevant IPR is used outside Hong Kong by a person other than the taxpayer for production of goods to be sold solely to the taxpayer, the proposed section 16EC(4)(b) will not be applicable).

59. While taking note of the examples provided by the Administration, as reproduced in **Appendix III**, members of the Bills Committee have also cited other possible scenarios and sought clarification from the Administration on the relevant tax deduction arrangements during the discussion. At the Bills Committee's request, the Administration has summarized in writing these other examples and set out the relevant tax deduction arrangements. The information is given in **Appendix IV**. The Administration has advised that it would cover the use of IPRs in cross-border activities, including the application of proposed section 16EC(4)(b), in the DIPNs to be issued by IRD.

60. Regarding the issue of offsetting transactions involved in the use of IPRs in cross-border activities, the Administration has informed the Bills Committee that SAT has confirmed that according to Article 40 of the "Implementation Measures of Special Tax Adjustments", "where the respective transactions involving payments and receipts between related parties are being offset, tax authorities conducting comparability analysis and making tax adjustments should, in principle, restore the transactions". The Administration considers that as it has already relayed to the Bills Committee the content of the written reply from SAT, there is no need to provide the relevant correspondence to the Bills Committee.

Departmental Interpretation and Practice Notes

61. In the course of the Bills Committee's deliberations, members have sought clarification from the Administration on the tax assessment practices and tax deduction arrangements under different scenarios. Some deputations have also raised queries on relevant aspects in their submissions. The Administration has provided relevant information at Bills Committee meetings and in its written responses. In view of the complexity and technicality of the issues concerned, the Bills Committee has requested and the Administration has agreed to set out the relevant arrangements in the DIPNs of IRD, covering the following matters arising from the Bill -

(a) the arrangements regarding the tax deduction for the purchase of IPRs the registration of assignment of which is still being processed and the clawback arrangements for invalidated/revoked/surrendered IPR registrations *(paragraph 19 refers)*;

(b) the arrangements for determining for tax purpose the true market value of an IPR *(paragraph 32 refers)*;

(c) the factors to be considered by the Commissioner in making his determination under proposed section 16EC(1)(c) *(paragraph 39 refers)*;

(d) eligibility for tax deduction for capital expenditure incurred on the purchase of IPRs which are used in cross-border activities, including the application of proposed section 16EC(4)(b) *(paragraph 59 refers)*;

(e) licensing of IPRs for use outside Hong Kong; and

(f) IPRs with registration in multiple jurisdictions.

62. At the request of the Bills Committee, the Administration has agreed to provide the final draft version of the DIPNs compiled pursuant to the provisions in the Bill and the requests of the Bills Committee to the Panel on Financial Affairs for information and comments in due course.

Committee Stage amendments

63. The legal adviser to the Bills Committee has pointed out that under the current drafting of proposed section 16EC(8), where the person in question is a natural person (Mr X), a corporation which is controlled by a relative of Mr X is not an associate of Mr X whereas a corporation which is controlled by a relative of Mr X's partner is. In response to the legal adviser's enquiry, the Administration has confirmed that it is in fact the policy to include such corporation as an associate of Mr X. Accordingly, the Administration will propose a Committee Stage amendment ("CSA") to the definition of "associate" to reflect this policy.

64. In the light of other enquiries of the legal adviser to the Bills Committee, the Administration will also propose CSAs to –

(a) replace references to "expenditure" by "capital expenditure" in the existing section 16E(1) and other appropriate provisions in the Bill for consistency sake;[16]

[16] The term "expenditure" is used in the existing section 16E (which concerns patent rights and rights to any know-how) while the term "capital expenditure" is used in proposed new section 16EA (which deals with copyright, registered design and registered trade mark). The Administration has confirmed that both sections refer to the expenditure of the same nature.

(b) replace "股份" by "部分" in the Chinese text of the existing section 16E(5), as "部分" is the accurate rendition of "share" in that provision; and

(c) replace " 該法團" by "首述法團" whenever it appears in the definition of "控制" under proposed new section 16EC(8), to strictly tally with the English text of the definition.

65. As advised by the Administration, both the present Bill and the Inland Revenue (Amendment) (No. 3) Bill 2011 have respectively proposed adding new provisions to section 89 of the existing IRO with a view to introducing new schedule for transitional provisions. Since the Inland Revenue (Amendment) (No. 3) Bill 2011 has already been passed by the Legislative Council on 8 June 2011, it is necessary for the Administration to introduce technical amendments to clauses 8 and 9 to re-number the relevant transitional provisions of the Bill.

66. The Bills Committee agrees to the Administration's proposed CSAs which are set out in **Appendix V**. The Bills Committee has not proposed any amendment in its name.

Follow-up actions required

67. As mentioned in paragraph 12 above, the Administration has agreed to relay to the Financial Secretary for future consideration outside the context of the Bill the suggestion of extending the proposed tax deduction scheme to more types of IPRs. The issue will also be referred to the Panel on Commerce and Industry for follow-up as appropriate.

68. As mentioned in paragraph 62 above, the Administration has agreed to provide the final draft version of the DIPNs compiled pursuant to the provisions in the Bill and the requests of the Bills Committee to the Panel on Financial Affairs for information and comments in due course.

Recommendation

69. The Bills Committee supports the resumption of the Second Reading debate on the Bill on 7 December 2011.

Advice sought

70. Members are invited to note the Bills Committee's deliberations and recommendation in paragraph 69.

Council Business Division 1
Legislative Council Secretariat
24 November 2011

Appendix I

Bills Committee on Inland Revenue (Amendment) (No. 2) Bill 2011

Membership List

Chairman	Hon Paul CHAN Mo-po, MH, JP
Members	Ir Dr Hon Raymond HO Chung-tai, SBS, S.B.St.J., JP Hon James TO Kun-sun Hon CHAN Kam-lam, SBS, JP Hon Miriam LAU Kin-yee, GBS, JP Hon Abraham SHEK Lai-him, SBS, JP Hon Audrey EU Yuet-mee, SC, JP Hon WONG Ting-kwong, BBS, JP Hon Mrs Regina IP LAU Suk-yee, GBS, JP (Total : 9 members)
Clerk	Ms Anita SIT
Legal Adviser	Ms Wendy KAN

Appendix II

Bills Committee on Inland Revenue (Amendment) (No. 2) Bill 2011

List of organizations which have submitted views to the Bills Committee

*1. Association of Chartered Certified Accountants Hong Kong

*2. The Chinese Manufacturers' Association of Hong Kong

*3. Federation of Hong Kong Industries

*4. Hong Kong Bar Association

*5. Hong Kong Institute of Certified Public Accountants

*6. The Hong Kong Institute of Patent Practitioners

*7. Hong Kong Institution of Engineers

8. Hong Kong Small and Medium Enterprises Association

9. Hong Kong Small and Medium Enterprises Development Association

*10. The Joint Liaison Committee on Taxation

*11. The Law Society of Hong Kong

*12. PricewaterhouseCoopers Limited

13. The Taxation Institute of Hong Kong

* *submitted written views only*

Examples provided in the Administration's letter dated 4 November 2011 (LC Paper No. CB(1)280/11-12(01)) on the tax deduction arrangements for intellectual property rights (IPRs) used in different cross-border activities

(A) *A Hong Kong company, after acquiring the proprietary interest of a Hong Kong registered trade mark[1], contracts a manufacturer in the Mainland to produce goods bearing the Hong Kong registered trade mark for sale in Hong Kong to produce profits chargeable to tax in Hong Kong.*

3. As the Hong Kong company has only purchased the Hong Kong registered trade mark and has not acquired the proprietary interest of that mark for the Mainland, it has no right to grant a licence to the Mainland manufacturer to use the relevant Mainland trade mark. In the above scenario, the Hong Kong company has not licensed the right to use the relevant trade mark to any person outside Hong Kong. Hence, section 16EC(4)(b) of the Bill is not applicable. Provided that other provisions of sections 16EA and 16EC are satisfied, the Hong Kong company is eligible for tax deduction in respect of the capital expenditure incurred on the purchase of the Hong Kong registered trade mark.

(B) *A Hong Kong company acquires the proprietary interest of a Hong Kong registered trade mark. The relevant mark has not been registered or used in the Mainland by anyone else. The Hong Kong company then registers the mark in the Mainland. For the purpose of contracting a manufacturer in the Mainland to produce goods bearing the Mainland registered trade mark, the Hong Kong company has licensed the right to use the Mainland registered trade mark to the Mainland manufacturer. The goods produced by the Mainland manufacturer are sold in Hong Kong by the Hong Kong company and produce profits chargeable to tax in Hong Kong.*

4. The Hong Kong company has only purchased the Hong Kong registered trade mark but not the Mainland registered trade mark. It has become the registered owner of the Mainland registered trade mark because it has subsequently registered the trade mark in the Mainland. The cost incurred is the Mainland registration fee only. The trade mark allowed to be used by the Mainland manufacturer through licensing arrangement is the one registered in the Mainland by the Hong Kong company and not the Hong Kong registered

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[1] The territorial scope of protection of a Hong Kong registered trade mark is solely restricted to Hong Kong.

trade mark purchased by the Hong Kong company in the first place. As such, section 16EC(4)(b) of the Bill is not applicable. Provided that other provisions of sections 16EA and 16EC are satisfied, the Hong Kong company is eligible for tax deduction in respect of the capital expenditure incurred on the purchase of the Hong Kong registered trade mark.

(C) *A Hong Kong company, after acquiring the proprietary interests of a trade mark registered both in Hong Kong and in the Mainland, contracts a manufacturer in the Mainland to produce goods bearing the trade mark by granting to the manufacturer a licence covering the right to use the Mainland registered trade mark. The goods produced by the Mainland manufacturer are then sold in Hong Kong and in the Mainland by the Hong Kong company and produce profits chargeable to tax in Hong Kong.*

5. As the Hong Kong registered trade mark purchased by the Hong Kong company is used by the company itself to produce profits chargeable to tax in Hong Kong, section 16EC(4)(b) of the Bill is not applicable. Provided that other provisions of sections 16EA and 16EC are satisfied, the Hong Kong company is eligible for tax deduction in respect of the capital expenditure incurred on the purchase of the Hong Kong registered trade mark.

6. Regarding the Mainland registered trade mark purchased by the Hong Kong company, different tax treatments should be adopted according to the uses of the registered trade mark. For the part used in production activities, since the Mainland registered trade mark is granted by the Hong Kong company to the Mainland manufacturer by means of a licence (either at cost or at no cost) for use in the latter's production activities, section 16EC(4)(b) of the Bill is applicable. The part of the capital expenditure incurred on the purchase of the Mainland registered trade mark for use in the production activities will not be allowed for tax deduction. However, for the part used in sales activities in the Mainland, as the Hong Kong company sells its own goods (the goods are sold either by the Hong Kong company itself or by a Mainland agent commissioned by the Hong Kong company) and the Mainland registered trade mark is not used by a person other than the Hong Kong company, section 16EC(4)(b) of the Bill is not applicable. Provided that other provisions of section 16EA and 16EC are satisfied, the Hong Kong company is eligible for tax deduction in respect of the capital expenditure incurred on the purchase of the part of the Mainland registered trade mark used in sales activities.

Examples set out in the Administration's letter dated 22 December 2011 (LC Paper No. CB(1)426/11-12(01)) to illustrate the application of section 16EC(4)(b) of the Bill

Example (1)

Company HK, carrying on a trading business in Hong Kong, has during the year of assessment 2011/12 purchased a trade mark registered in Hong Kong at a cost of $1,000,000. The trade mark has not been registered in places other than Hong Kong. Company HK contracted Company M, a manufacturer located in the Mainland to produce goods bearing the Hong Kong registered trade mark. The finished goods were sold by Company HK to customers in Hong Kong and the profits derived are chargeable to tax in Hong Kong.

Company HK has only purchased the Hong Kong registered trade mark and has not acquired any right to use the trade mark in places other than Hong Kong. The trade mark used by Company M when manufacturing the goods in the Mainland is an unregistered trade mark in the Mainland, not the trade mark registered in Hong Kong. In the circumstances, section 16EC(4)(b) of the Bill is not applicable. Since the profits derived by Company HK from selling the finished goods are chargeable to tax in Hong Kong and in accordance with section 16EA(3) of the Bill, it is entitled to deduct one-fifth of the purchase cost of the Hong Kong registered trade mark for the year of assessment 2011/12 in the amount of $200,000 (i.e. $1,000,000 ÷ 5).

Example (2)

Company HK, carrying on a trading business in Hong Kong, has during the year of assessment 2011/12 purchased a trade mark registered in Hong Kong at a cost of $2,000,000. The trade mark has not been registered in places other than Hong Kong. Company HK subsequently registered the trade mark in the Mainland and contracted a Mainland manufacturer, Company M, to produce in the Mainland goods bearing the Mainland registered trade mark. The goods produced by Company

M were sold in Hong Kong by Company HK and the profits derived are chargeable to tax in Hong Kong.

Company HK has only purchased the Hong Kong registered trade mark but not the Mainland registered trade mark. It becomes the registered owner of the Mainland registered trade mark because it has subsequently registered the trade mark in the Mainland. The trade mark used by Company M in the production of goods in the Mainland is the one registered in the Mainland by the Company HK and not the Hong Kong registered trade mark purchased by Company HK in the first place. As such, section 16EC(4)(b) of the Bill is not applicable. Since the profits derived by Company HK from selling the finished goods are chargeable to tax in Hong Kong and in accordance with section 16EA(3) of the Bill, it is entitled to deduct one-fifth of the purchase cost of Hong Kong registered trade mark for the year of assessment 2011/12 in the amount of $400,000 (i.e. $2,000,000 ÷ 5).

Example (3)

Company HK, carrying on a trading business in Hong Kong, has during the year of assessment 2011/12 purchased a trade mark registered both in Hong Kong and the Mainland at a total cost of $3,000,000. The Hong Kong registered trade mark and the Mainland registered trade mark are each valued at $1,500,000. Company HK contracted Company M, a contract manufacturer located in the Mainland, to produce goods bearing the trade mark.

Scenario 1
All of the finished goods were sold by Company HK to customers in Hong Kong and the profits derived are chargeable to tax in Hong Kong.

Insofar as the trade mark registered in Hong Kong is concerned, it was used by the Company HK itself for selling the finished goods to produce profits chargeable to tax in Hong Kong. Section 16EC(4)(b) of the Bill is therefore not applicable. In the year of assessment 2011/12, Company HK is entitled to deduct one-fifth of the purchase cost of the Hong Kong registered trade mark pursuant to section 16EA(3) of the Bill for the year

of assessment 2011/12 in the amount of $300,000 (i.e. $1,500,000 ÷ 5).

As for the Mainland registered trade mark, it was used by Company M for production of goods in the Mainland. As such, section 16EC(4)(b) of the Bill is applicable and the purchase price of $1,500,000 for the Mainland registered trade mark is not deductible.

Scenario 2

The finished goods were sold by Company HK to customers in Hong Kong and the United States. The profits so derived are chargeable to tax in Hong Kong.

Insofar as the trade mark registered in Hong Kong is concerned, it was used by Company HK itself for selling of the finished goods to produce profits chargeable to tax in Hong Kong. In addition, Company HK when selling the goods in the US market is not using the trade mark registered in Hong Kong. As such, section 16EC(4)(b) of the Bill is not applicable. In the year of assessment 2011/12, Company HK is entitled to deduct one-fifth of the purchase cost of the Hong Kong registered trade mark pursuant to section 16EA(3) of the Bill for the year of assessment 2011/12 in the amount of $300,000 (i.e. $1,500,000 ÷ 5).

As for the Mainland registered trade mark, it was used by Company M for production of goods in the Mainland. As such, section 16EC(4)(b) of the Bill is applicable and the purchase price of $1,500,000 for the Mainland registered trade mark is not deductible.

Scenario 3

Company M manufactured 1,000,000 pieces of goods during the year of assessment 2011/12 and they were sold by Company HK to customers in Hong Kong, the United States and the Mainland in the respective quantities of 200,000, 200,000 and 600,000. The profits so derived are all chargeable to tax in Hong Kong.

Insofar as the trade mark registered in Hong Kong is concerned, it was used by Company HK itself for selling of finished goods to produce profits chargeable to tax in Hong Kong. In addition, Company HK when selling the goods in the US market is not using the trade mark

registered in Hong Kong. As such, section 16EC(4)(b) of the Bill is not applicable. In the year of assessment 2011/12, Company HK is entitled to deduct one-fifth of the purchase cost of the Hong Kong registered trade mark pursuant to section 16EA(3) of the Bill in the amount of $300,000 (i.e. $1,500,000 ÷ 5).

As for the Mainland registered trade mark, it was partly used by Company M for production of goods in the Mainland and partly used by Company HK for selling some of the finished goods in the Mainland. In the circumstances, section 16EC(4)(b) of the Bill is applicable to the part of the Mainland registered trade mark that was used by Company M in the Mainland manufacturing activities. Nevertheless, Company HK is still entitled to deduct part of purchase price of the Mainland registered trade mark which was used by itself to sell the finished goods in the Mainland and has produced profits chargeable to tax in Hong Kong. The amount of deduction for the Mainland registered trade mark is calculated as follows:

$$\text{Purchase price of the Mainland registered trade mark} \times \frac{\text{No. of units sold in the Mainland}}{\text{No. of units manufactured and sold in the Mainland}} \div 5$$

$$= \$1{,}500{,}000 \times \frac{600{,}000}{1{,}600{,}000} \div 5$$

$$= \underline{\$112{,}500}$$

The allowable deduction in respect of the purchase price of the Mainland registered trade mark for the year of assessment 2011/12 is $112,500.

Draft

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

Committee Stage

Amendments to be moved by the
Secretary for Financial Services and the Treasury

Clause	Amendment Proposed
5	By adding before subclause (1)— "(1A) Section 16E(1), before "expenditure"— **Add** "capital".".
5(3)	In the proposed section 16E(2), by adding "capital" before "expenditure".
5(6)	In the proposed section 16E(3A), by adding "capital" before "expenditure".
5	By adding— "(9A) Section 16E(5), Chinese text— **Repeal** "股份" **Substitute** "部分".".

5(10) In the proposed section 16E(8)(a), by adding "capital" before "expenditure".

6 In the proposed section 16EC(6), by adding "capital" before "expenditure or".

6 In the proposed section 16EC(8), in the definition of ***associate***, in paragraph (a)(v), by adding—

"(AA) a relative of the first-mentioned person;".

6 In the proposed section 16EC(8), in the Chinese text, in the definition of ***控制***, by deleting "該法團" (wherever appearing) and substituting "首述法團".

8 In the proposed section 89(7)—

(a) by deleting "(7)" and substituting "(8)";

(b) by deleting "Schedule 22" and substituting "Schedule 24".

9 In the heading, by deleting "**Schedule 22**" and substituting "**Schedule 24**".

9 In the proposed Schedule 22—

(a) by deleting—

"**Schedule 22** [s. 89(7)]"

and substituting—

"**Schedule 24** [s. 89(8)]";

(b) in section 1—

(i) by deleting “(2B) and (4)” and substituting “(2B), (4) and (5)”;

(ii) by deleting “5(1), (3), (4), (7) and (8)” and substituting “5(1A), (1), (3), (4), (7), (8) and (9A)”.