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Hon Kenneth Leung
Chairman
Bills Committee on Inland Revenue (Amendment) (No. 2) Bill 2018
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Submission on the Inland Revenue (Amendment) (No. 2) Bill 2018 (the Bill)

Dear Hon Kenneth Leung,

Thank you for inviting our firm to make a submission on the Bill, which seeks to expand the scope of section 16EA which allows the deduction of capital expenditure incurred on acquiring intellectual property rights (IPRs) for profits tax purposes. Three specific additional IPRs, namely layout-design (topography) rights, plant variety rights and performer's economic rights, will be added.

The expansion of the scope to include these intellectual properties, we believe, is essential to encourage the development of the certain industries, which employ these intellectual properties in their business operations, in Hong Kong. While we welcome the HKSAR Government's proposal of expanding the scope of profits tax deduction for purchase of IPRs, we set out below our two comments on the Bill for your consideration.

No deduction for purchase of IPRs from associates

While the Bill seeks to grant a tax deduction for the capital expenditure incurred on the acquisition of the three IPRs in addition to the five existing ones under section 16EA, such deduction will similarly be subject to the specific anti-avoidance rules in the existing IPR deduction regime. In particular, deduction will be denied under existing section 16EC(2) of the Inland Revenue Ordinance (IRO) if the IPR is purchased wholly or partly from an associate.

We understand that section 16EC(2) is a specific anti-avoidance measure to safeguard against possible abuse of the deduction through transfer of IPR among group companies. When the existing IPR regime was introduced in 2011[1], we have already made a submission expressing our concern that the section 16EC(2) would unintentionally affect certain normal merger and acquisition activities (our previous submission is attached as reference).

[1] The existing intellectual property rights deduction regime was introduced by the Inland Revenue (Amendment) (No 2) Bill 2011

Furthermore it is common for a business group to transfer the ownership of an IPR which is developed and originally owned by an overseas group company to a Hong Kong group company for genuine and legitimate commercial reasons (e.g. for better asset protection purpose). However, under section 16EC(2), no deduction will be allowed for the purchase cost of the IPR incurred by the Hong Kong company (even if the purchase cost is on an arm's length basis) if the overseas company is an associate as defined in section 16EC(8), despite the Hong Kong company may derive royalty income chargeable to profits tax in Hong Kong from the IPR purchased.

Section 16EC(2) may be necessary when there are no transfer pricing rules in the IRO and the Inland Revenue Department has to rely on both the general and specific anti-avoidance provisions in the IRO to safeguard against any abuse. With the introduction of transfer pricing rules into the IRO by the Inland Revenue (Amendment) (No 6) Bill 2017, we believe the forthcoming transfer pricing rules will be sufficient to deal with the above mentioned possible abuse and it is time for the Government to reconsider to remove a blanket denial of deduction for all purchases from an associate as imposed by section 16EC(2). Having such blanket denial for all IPRs purchased from an associate is also not conducive to promoting Hong Kong as an intellectual property holding or trading hub.

In this regard, we note that Singapore generally allows deduction (in the form of writing-down allowances over a specified period) for capital expenditure incurred in acquiring an IPR from a related party except in certain limited circumstances[2]. To support the purchase cost is on an arm's length basis, there is a requirement for taxpayers to provide an independent valuation report if the capital expenditure incurred in acquiring an IPR from a related party is S$0.5 million or more.

The deeming provision on assignment of performer's rights

While the main objective of the Bill is to grant a tax deduction for the acquisition costs of three more IPRs, the Bill also contains a new deeming provision which deems any sums received by or accrued to a performer or an organiser for an assignment of, or an agreement to assign, a performer's right in relation to a performance given by the performer in Hong Kong as taxable trading receipts.

This deeming provision appears to be a safeguard against any abuse of the deduction of acquisition cost of performer's right in relation to a performance given by the performer in Hong Kong. However, this is not clear from reading the Legislative Council Brief. In this regard, we would like to seek a clarification from the Administration on the rationale and legislative intent of such deeming provision as well as the business models / circumstances envisaged by the Administration where such deeming provision is necessary to bring sums that would otherwise not chargeable to profits tax back to the Hong Kong tax net. In particular, we would like to seek the Administration's clarification on whether it is its legislative intent to deem such sums as taxable in Hong Kong even if the expenditure incurred by the assignee in acquiring such performer's rights is not tax deductible in Hong Kong (e.g. a non-resident person who does not carry on any trade or business in Hong Kong acquired the right from a non-resident performer for making copies of the fixation of his/her performance in Hong Kong for distribution outside Hong Kong).

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[2] https://www.iras.gov.sg/irashome/Businesses/Companies/Working-out-Corporate-Income-Taxes/Claiming-Allowances/Writing-Down-Allowances-for-Intellectual-Property-Rights/

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We would be pleased to provide further comments if necessary. If you have any questions on our submission, please feel free to contact me (charles.lee@cn.pwc.com) or Fergus Wong (fergus.wt.wong@hk.pwc.com).

Yours sincerely,
For and on behalf of PricewaterhouseCoopers Limited

Charles Lee
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Hon Paul CHAN Mo-po, MH, JP
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Bills Committee on Inland Revenue (Amendment) (No. 2) Bill 2011
Legislative Council
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20 May 2011

Dear Hon Paul Chan,

Submission on the Inland Revenue (Amendment) (No. 2) Bill 2011

We refer to your invitation for submission on the Inland Revenue (Amendment) (No. 2) Bill 2011 ("Bill") and set out below our comments on the Bill for your consideration.

Practical issues arising from the proposed Section 16EC(4)(b)

As stated in the Legislative Council Brief on the Bill, the justifications of the Bill are "*to promote the wider application of intellectual property rights by enterprises, to encourage innovation and upgrading and to facilitate development of creative industries in Hong Kong*". Given this legislative intent, it is doubtful whether the current draft legislation would be able to serve its intended purpose. This is particularly true given the unclear sourcing rule for royalties / licensing fees under the current guidance and assessing practice of the Inland Revenue Department ("IRD"). This is further illustrated by the situations and examples discussed below.

1. Licensing of specified intellectual property rights ("specified IPRs") for use outside Hong Kong

   Example 1:

   A Hong Kong company is engaged in the business of acquiring specified IPRs from different unrelated sources, carrying out further improvement / enhancement work on the specified IPRs in Hong Kong and then licensing them to overseas customers for use outside Hong Kong in return of a license fee.

   Under such situation, deduction of the purchase cost of the specified IPRs incurred by the Hong Kong company will be denied pursuant to the proposed section 16EC(4)(b), as the specified IPRs are used wholly or principally outside Hong Kong by someone else under a licence. On the other hand, it is currently unclear whether the license fees received by the Hong Kong company will be subject to Hong Kong profits tax based on our understanding of the current practice of the IRD in determining the source of royalty income. Revised Departmental Interpretation & Practice Notes No. 21 issued in December 2009 only spells out the IRD's view on the sourcing rule for royalties arising from a "license and sub-license" arrangement, but not an "acquisition and license" arrangement. If the IRD treats the licensing fees in this case as having a Hong Kong source (say following the *Lam Soon Trademark Ltd v CIR* case), the Hong Kong company will be in an awkward position whereby the costs of the specified IPRs are not deductible whereas the licensing fees are taxable for Hong Kong profits tax purposes.

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The uncertainty and potential absurdity mentioned above will certainly discourage Hong Kong companies from holding and exploiting intellectual property ("IP") in Hong Kong and create an obstacle for developing Hong Kong as an IP hub.

Example 2:

Similarly, a Hong Kong company engaged in garment trading may purchase a registered trademark or design from an overseas unrelated company, carry out further improvement / enhancement work on the trademark / design in Hong Kong (to make use of the skilled labor, advanced technology and protection of IP rights in Hong Kong) and then license the trademark or design to a manufacturing subsidiary in China (to take advantage of the low production cost in China) for production of garments. The Hong Kong company will receive royalty income from the subsidiary for the use of the trademark / design in China and purchase the finished goods from the subsidiary at an arm's length price for resale to its customers.

Similar to Example 1 above, deduction of the purchase cost of the trademark /design incurred by the Hong Kong company will be denied under the proposed section 16EC(4)(b), as the trademark / design is used wholly or principally outside Hong Kong by the subsidiary in China under a licensing arrangement. On the other side, it is unclear whether the royalty income received by the Hong Kong company from the subsidiary will be subject to Hong Kong profits tax.

This would again affect the normal business activities of Hong Kong companies and create an unintended result similar to that of applying section 39E of the Inland Revenue Ordinance to Hong Kong companies engaged in cross-border processing trade business.

2. Use of specified IPR outside Hong Kong under contract/import processing

Referring to the definition of "licence" in the Bill, we would like to seek a clarification from the Administration on whether provision of a specified IPR by a Hong Kong taxpayer to an overseas manufacturing entity (free of charge) for use in the production of goods for the Hong Kong taxpayer under a contract processing or an import processing arrangement will be regarded as a "licence" for the purpose of section 16EC(4)(b).

If the answer is yes and on the assumption that the proposed section 16EC(4)(b) would not be revised or removed, we are of the view that the definition of licence should be revised to specifically exclude these kinds of arrangement from the definition in order not to affect the normal business activities of Hong Kong companies engaged in cross-border processing trade.

Under the current practice of the IRD, 50% of the depreciation allowance on the plant and machinery used outside Hong Kong under a contract processing arrangement is granted to the Hong Kong taxpayer as a concession. In view of this current practice, we would also like to seek a clarification from the Administration on whether similar concession will be granted to Hong Kong taxpayers for deducting 50% of the cost of the specified IPR under a similar contract processing arrangement should the current draft legislation remain unchanged.

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In view of the above, we are of the view that the provisions in the proposed section 16EC(4)(b) should either be revisited/removed. In fact, we could not see the necessity of including the proposed section 16EC(4)(b) as any specified capital expenditure not incurred in the production of assessable profits would have already been denied under the proposed section 16EA(2) and the IRD can also apply the general anti-avoidance provisions in section 61 or 61A to any arrangement involving tax avoidance.

In addition, the sourcing rule for royalties/licensing fees should be further clarified. In particular, the IRD should clarify the rule for determining the source of royalties arising from licensing an acquired or self-developed IP and whether apportionment is possible say, for example, when the acquisition is effected / development is done in Hong Kong whereas the licensing is effected outside Hong Kong.

Denial of deduction for purchase from associate

While we appreciate the necessity for the Administration to include anti-avoidance provisions in respect of purchase of specified IPRs from an associated party in the draft legislation, the current broad-brush approach of denying deduction in respect of *any* specified IPR purchased wholly or partly from an associate as proposed in section 16EC(2) would again unintentionally affect certain normal merger and acquisition transactions.

For example, a Hong Kong company would like to acquire a company (the target) which holds numerous specified IPRs registered in various jurisdictions and transfer the ownership of these specified IPRs to itself for a commercial or legal reason. Due to the complicated and lengthy legal procedures of transferring the ownerships of such specified IPRs in various jurisdictions, it is often difficult in practice for the Hong Kong company to finish the transfer of all the specified IPRs within a reasonable short period of time before the acquisition. In order to avoid any delay in the acquisition process, the Hong Kong company will instead purchase these specified IPRs from the target after the acquisition and by that time, the target has already become an associate of the Hong Kong company. In such case, the costs of acquiring the specified IPRs incurred by the Hong Kong company will be denied for deduction under the proposed section 16EC(2). As such, we suggest that the Administration consider putting an escape clause in the section such that normal merger & acquisition activities will not be affected inadvertently.

If you have any questions on our submission, please feel free to contact me at peter.sh.yu@hk.pwc.com or Mr Fergus Wong, our technical director, at fergus.wt.wong@hk.pwc.com

Yours sincerely,
For and on behalf of PricewaterhouseCoopers Limited

Peter Yu
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