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The Honorable Kenneth Leung
Chairman
Bills Committee on Inland Revenue (Amendment) (No.2) Bill 2018
Legislative Council Secretariat
Hong Kong

Dear Honorable Kenneth Leung,

Submission on the Inland Revenue (Amendment) (No.2) Bill 2018 (the Bill)

We welcome the introduction of the Bill that seeks to extend the scope of the current tax deduction regime under sections 16EA, 16EB and 16EC of the Inland Revenue Ordinance (IRO) for certain specified intellectual property rights (IPRs), to include three new types of IPRs.

Namely, these three new types of IPRs are: (i) performer's economic right; (ii) protected layout-design (topography) right; and (iii) protected plant variety right. This extension should help Hong Kong position itself as an IPR hub, develop its innovation and creative industries, and drive the re-industrialization of Hong Kong.

We provide below our comments on certain provisions of the Bill.

Scope of section 15(1)(bb) and its enforcement

Under the literal terms of section 15(1)(bb), any sums received by a person (presumably by a non-resident in many cases) from the assignment of a performer's right in respect of a performance made in Hong Kong will be deemed profits of the person chargeable to tax in Hong Kong. Such an assignment need not be made to a Hong Kong person before any sums received will be chargeable to tax in Hong Kong.

If this is the intended scope of the section, the next question would be: how in practice would a tax assessment of the non-resident be made (including the deemed profit rate to be adopted in practice, absent a statutory rate) and collection of tax enforced, where the assignee or the payer is not a Hong Kong person.

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Such an issue of tax assessment and collection would be more relevant in the context of the proposed deeming provision under section 15(1)(bb) than that of section 15(1)(b) of the IRO.

This would be the case because, given that section 15(1)(b) only charges sums received for the use, or right to use, of an IPR in Hong Kong, the payer involved would most likely be a Hong Kong person. However, the payer for sums deemed chargeable to tax in Hong Kong under section 15(1)(bb) may more likely not be a Hong Kong person.

For this reason, the Bills Committee may need to clarify with the Government on the issue.

Some provisions in section 16EC would be unnecessary and undesirable

The Bill simply provides that the tax deduction for the three new types of IPRs will be subject to the existing terms of section 16EC of the IRO, while making no change to the current scope and application of the anti-avoidance provisions contained in the section.

Modelled on section 39E(1)(b)(i) of the IRO, Section 16EC(4)(b) was first enacted in December 2011. The former section has been controversially invoked by the Inland Revenue Department (IRD) to deny tax depreciation allowances on capital expenditure incurred by Hong Kong taxpayers for plant or machinery provided rent-free by such taxpayers to their overseas contract manufacturers, mostly in mainland China under import processing arrangements, even though the profits derived by taxpayers from their sales of goods produced under such arrangements are fully chargeable to tax in Hong Kong.

The Institute then opposed to the enactment of section 16EC(4)(b). Our view then was that section 16EC(4)(b) would be unnecessary and undesirable. We remain of the same view today.

No "tax symmetry" problem

Section 16EC(4)(b) would be unnecessary because if the income derived from the use of the IPRs (regardless of whether used outside Hong Kong under a licensing arrangement or not) is not that of the taxpayers in Hong Kong, or is offshore in nature, the relevant costs would already be disallowable under the terms of sections 16(1) and 16EA(6) of the IRO, as not being expenditure incurred in the production of profits chargeable to tax in Hong Kong.

The existence of section 16EC(4)(b) would also be undesirable given how the IRD has interpreted the section in practice (similar to that of its controversial interpretation of section 39E(i)(b)(i) noted above).

The terms of section 16EC(4)(b), enacted as a specific anti-avoidance provision, provide that where a relevant IPR is wholly or principally used outside Hong Kong by a person other than the taxpayer under the term of a license (even on a royalty-free basis), the tax deduction under section 16EA will be denied.

As a result of the IRD's controversial interpretation of section 16EC(4)(b), taxpayers will not be able to obtain the tax deduction for the purchase costs of the IPRs in many legitimate cases where no tax avoidance is involved.

Example 1 below would illustrate the issues involved and why the retention of section 16EC(4)(b) in the IRO would be undesirable.

Example 1

Take for example the case of a Hong Kong company that purchases, from a third party, a layout-design (topography) right in certain integrated circuits (IC Right) for HK$8 million, the IC Right in question being protected under the law of mainland China. Further assume that the Hong Kong company then procures an unrelated contract manufacturer in mainland China under import processing arrangements to produce goods on behalf of the Hong Kong company, and in the process allows the contract manufacturer to use the IC Right royalty free. If the goods incorporating the IC Right so manufactured were then sold by the Hong Kong company to customers in Hong Kong, the profits so derived would be fully taxable in Hong Kong as being Hong Kong-sourced income.

In the above circumstances however, the IRD would consider that the Hong Kong company has effectively granted the contract manufacturer in mainland China (being a person other than the Hong Kong company as the taxpayer) a license for the use of the IC Right wholly or principally outside Hong Kong. As such, under section 16EC(4)(b), the IRD will deny the Hong Kong company's claim for a tax deduction of the purchase cost of HK$8 million in respect of the IC Right. This would be the case even though the profits derived by the Hong Kong company from the trading of the goods manufactured by the contract manufacturer in mainland China were fully chargeable to tax in Hong Kong.

The existence of section 16EC(4)(b), coupled with the IRD's interpretation and application of the section explained above, would undermine the very purposes of introducing the tax deduction regime for IPRs.

So-called "offsetting transactions" would not create transfer pricing issues in Hong Kong and overseas

No transfer pricing issues created

We understand that the Government is of the view that granting tax deductions for the relevant IPR in the circumstances of Example 1 above would be against the "transfer pricing principles".

Apparently, this view is based on the transfer pricing principles advocated by the Organization for Economic Cooperation and Development (OECD). It appears that the Government has taken the view that under the OECD transfer pricing principles, a Hong Kong taxpayer cannot simply allow its contract manufacturer to use the relevant IPR without charging royalties (regardless that the contract manufacturer only employs the relevant IPR for the production of goods ordered by the taxpayer).

Under such a view, the taxpayer should charge the contract manufacturer royalties on an arm's length basis. In any case, the Government is apparently of the view that royalties are implicitly charged by way of being offset against the purchase price of goods paid by the taxpayer to its contract manufacturer, i.e., the so-called "offsetting transactions", thereby creating transfer pricing issues in Hong Kong and overseas where the contract manufacturer is located.

The Institute however does not consider that the so-called "offsetting transactions" would create any transfer pricing issues in Hong Kong and overseas. Example 2 shown in the Appendix to this submission would illustrate our view in this regard.

Section 16EC(4)(b) unnecessary even if royalties under "offsetting transactions" regarded as offshore

It appears to the Institute that the Government's imputation of the offshore royalty income to the taxpayer under the "offsetting transactions" illustrated in Example 2 is merely a variation of its pursuit of the "territorial source" and "tax symmetry" principle.

If so and as noted above, sections 16(1) and 16EA(6), which grant tax deductions only when the relevant IPR is used in the production of profits chargeable to tax in Hong Kong, would already appear to be available to disallow the deductions. Thus, in any case, there appears to be no need to further enact section 16EC(4)(b) for the Government's pursuit of the "territorial source " and "tax symmetry" principle under the "offsetting transactions" scenario.

Furthermore, under the OECD transfer pricing principles, the notion of "offsetting transactions" may more apply to the offset between two separate and distinct transactions. Such a notion of "offsetting transactions" may not necessarily apply to a royalty-free license of the relevant IPR under a contract manufacturing arrangement, whereby the contract manufacturer is only allowed to use the relevant IPR as part of the terms of an integral commercial arrangement for the manufacturing of goods for the taxpayer.

"Offsetting transactions" cannot undermine the taxing rights of overseas jurisdictions

The Government has indicated that if Hong Kong were to grant tax deductions for the relevant IPR in the circumstances of Example 1 above, Hong Kong could be viewed as encouraging taxpayers not to charge royalties and thus avoiding their tax liabilities on the "royalty income" derived from the overseas jurisdictions where their overseas contract manufacturers are located. Hong Kong could then be accused by the relevant overseas tax authorities of engaging in a harmful tax competition with them.

The Institute is however of the view that whether to grant tax deductions or not for the relevant IPR is essentially a matter of how Hong Kong administers its domestic tax law and cannot undermine the taxing rights of the overseas jurisdiction in respect of the "royalty income" of the Hong Kong taxpayer.

Regardless of whether Hong Kong grants tax deductions for the relevant IPR or not, the overseas tax jurisdiction can do what it considers appropriate in respect of the "royalty income" (possibly on an imputed basis if needed) of the Hong Kong taxpayer.

In this regard, we note that Singapore grants tax depreciation allowances on plant or machinery consigned by Singapore taxpayers to their contract manufacturers outside of Singapore, provided that income from such contract manufacturing arrangements is chargeable to tax in Singapore.

Thus far, we are not aware that any overseas jurisdictions have accused Singapore that its granting of tax depreciation allowances to taxpayers in Singapore in the aforesaid circumstances have undermined their taxing rights.

Royalties under contract manufacturing arrangements could justifiably be treated as Hong Kong-sourced

If the Government takes the view that royalties should actually be charged or notionally imputed, the Government may consider allowing that any overseas withholding taxes suffered on such royalties by a Hong Kong taxpayer in Example 1-type cases be tax creditable in Hong Kong (where there is a comprehensive double taxation arrangement between Hong Kong and the overseas jurisdiction concerned). The granting of a tax credit in Hong Kong in such cases would be on the premise that the IRD could justifiably treat any actual or implicit royalty as being Hong Kong sourced income.

We consider that treating such royalties as being Hong Kong sourced income would be justifiable. This is the case, given that any actual or imputed royalties in the circumstances can be regarded as arising from an integral part of the operations undertaken by the taxpayer in Hong Kong for securing the supply of goods traded by the taxpayer in Hong Kong.

In this regard, we also note that in a recent written response to a question raised by a lawmaker in the Legislative Council, the Secretary for Financial Services and Treasury, Mr. James Lau, has indicated that he has communicated with the industry and is re-examining the issue.

We propose that the Bills Committee raise all the above issues in relation to section 16EC(4b) with the Government.

Separately, given that Hong Kong will soon introduce comprehensive transfer pricing legislation for related party transactions, we propose that the Bills Committee explore with the Government whether the Bill could also remove the restrictions imposed under section 16EC(2) that costs incurred on the purchase of IPRs from an associate will be denied.

We trust the above is of use to the Bills Committee in its scrutiny of the Bill. Should you wish us to elaborate on any of the above points, please feel free to contact us.

Yours sincerely,

For and on behalf of
The Taxation Institute of Hong Kong

Appendix

Example 2:

Assumptions:

(i) a Hong Kong taxpayer allows its contract manufacturer to use its registered IC Right on a "royalty-free" basis for the manufacturing of goods ordered by the taxpayer;

(ii) the Hong Kong taxpayer pays HK$1,200,000 for the purchase of goods from the contract manufacturer; and

(iii) the implicit royalty for the IC Right is HK$50,000 and

(iv) the purchase cost of the IC Right is, say, HK$8,000,000.

Under the so-called "offsetting transactions", the price of goods sold by the contract manufacturer to the Hong Kong taxpayer of HK$1,200,000 under the "royalty-free" license of the IC Right should be grossed-up to reflect the implicit royalty.

As such, the actual payment of HK$1,200,000 is grossed-up as comprising of a sales price of goods of HK$1,250,000 offset by the implicit royalty of HK$50,000 paid by the contract manufacturer to the Hong Kong taxpayer. The result is therefore a net payment of HK$1,200,000.

The financial effect of the so-called "offsetting transactions" is analyzed below.

Profit and loss account of the Hong Kong taxpayer

	HK$	
Sales of goods (say)	1,500,000	
Cost of goods	1,200,000	Cost of goods paid to the contract manufacturer HK$1,250,000, less implicit royalty of HK$50,000 received from the contract manufacturer
Gross profit level	**300,000**	

Profit and loss account of the overseas contract manufacturer

	HK$	
Sales of goods	1,200,000	Gross sales price of goods HK$1,250,000, less implicit royalty of HK$50,000 paid by the contract manufacturer
Less: cost of manufacturing (say)	(1,000,000)	
Gross profit level	**200,000**	

As shown above, whether the purchase price of goods is grossed up or not, the actual payment between the Hong Kong taxpayer and the overseas contract manufacturer for the "offsetting transactions" involved would remain the same at HK$1,200,000. As such, the profit levels of both the Hong Kong taxpayer and the overseas contract manufacturer would remain the same at HK$300,000 and HK$200,000 respectively.

This example illustrates that even if royalties are imputed and then offset, the gross profit levels of both the Hong Kong taxpayer and the overseas contract manufacturer would remain the same, indicating that no transfer pricing issues are involved in Hong Kong and overseas under the so-called "offsetting transactions".