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Paper for the House Committee

**Report of the Bills Committee on
Inland Revenue (Amendment) (No. 2) Bill 2018**

Purpose

This paper reports on the deliberations of the Bills Committee on Inland Revenue (Amendment) (No. 2) Bill 2018 ("the Bills Committee").

Background

2. At present, capital expenditure incurred for the purchase of five categories of intellectual property rights ("IPRs"), i.e. copyright, registered designs, registered trade marks, patent rights and rights to know-how specified under sections 16E and 16EA of the Inland Revenue Ordinance (Cap. 112) ("IRO") (hereafter referred to as "the existing five categories of IPRs") and their corresponding rights subsisting/protected under the law of a place outside Hong Kong is deductible when assessing profits tax. Besides, expenditure relating to the registration of a trade mark or design, or the registration or grant of a patent that is used for producing taxable profits is deductible under section 16(1)(g) of IRO.

3. To promote Hong Kong as an intellectual property ("IP") trading hub in the region, the Financial Secretary ("FS") announced in the 2016-17 Budget that the Administration would expand the scope of profits tax deduction for capital expenditure incurred for the purchase of IPRs from the existing five categories of IPRs to eight. The three additional categories of IPRs are performer's economic rights, protected layout-design (topography) rights and protected plant variety rights (hereafter referred to as "the three additional categories of IPRs").

Inland Revenue (Amendment) (No. 2) Bill 2018

4. The Inland Revenue (Amendment) (No. 2) Bill 2018 ("the Bill") was published in the Gazette on 23 March 2018 and received its First Reading at the Council meeting of 11 April 2018. The objectives of the Bill are to amend IRO to: (a) expand the scope of profits tax deduction for capital expenditure incurred for the purchase of IPRs to cover the three additional categories of IPRs; (b) allow deduction of expenses for the grant of plant variety rights; (c) deem certain sums to be trading receipts chargeable to tax; and (d) provide for related matters. The key provisions of the Bill are set out below.

Expanding the scope of profits tax deduction to cover the three additional categories of intellectual property rights

5. Clause 5 of the Bill proposes to amend section 16EA of IRO to allow profits tax deduction for capital expenditure incurred for the purchase of the three additional categories of IPRs during a year of assessment beginning on or after 1 April 2018 if the required conditions are met. For this purpose, Clause 5(9) of the Bill proposes to amend section 16EA(11) of IRO to add the following definitions of the three additional categories of IPRs:

- (a) *Performer's economic right* refers to a right as provided under section 215(1)(a), (b), (c) or (d) of the Copyright Ordinance (Cap. 528) ("CO") and conferred by Part III of CO on a performer, which means the right in respect of reproduction, distribution and making available to the public copies of a fixation of their performances,¹ and the right for renting to the public copies of a sound recording of their performances or its corresponding rights subsisting under the law of a place outside Hong Kong;
- (b) *Protected layout-design (topography) right* refers to a right in a layout-design (topography) that is protected under section 3 of the Layout-design (Topography) of Integrated

¹ Under section 200(2) of the Copyright Ordinance (Cap. 528), a performance means a dramatic performance (which includes dance and mime), a musical performance, a reading or recitation of a literary work, a performance of an artistic work, an expression of folklore or a performance of a variety act or similar presentation.

Circuits Ordinance (Cap. 445)² ("LDTICO") or its corresponding rights subsisting under the law of a place outside Hong Kong; and

- (c) *Protected plant variety right* refers to a right granted under Part III of the Plant Varieties Protection Ordinance (Cap. 490) ("PVPO") or its corresponding rights subsisting under the law of a place outside Hong Kong.³

Deemed trading receipts to cover sums received in relation to intellectual property rights

6. Under section 15 of IRO, any sum, not otherwise chargeable to profits tax, received by or accrued to a person for the use, or the right to use, of various categories of IPRs in Hong Kong (or for the use, or the right to use, of such IPRs outside Hong Kong but the sums are deductible in ascertaining the assessable profits of that person) should be deemed as receipts arising in or derived from Hong Kong from a trade, profession or business carried on in Hong Kong. Clause 3(1) and (2) of the Bill proposes to amend the said section to make it clear that the above arrangement also applies to the three additional categories of IPRs. Further, clause 3(3) of the Bill proposes to amend section 15 of IRO to

² Under the Layout-design (Topography) of Integrated Circuits Ordinance (Cap. 445), for layout-design (topography) of integrated circuits ("ICs") to be protected, it must be original, and recorded in documentary form or incorporated into an IC. A qualified owner has the right to reproduce or commercially exploit his protected layout-design (topography). If a layout-design (topography) has not been commercially exploited anywhere in the world, the term of the protection will end 15 years after the end of the year in which it was created, but if it has so been commercially exploited, the term of the protection will end 10 years after the end of the year in which it was first commercially exploited.

³ Under the Plant Varieties Protection Ordinance (Cap. 490) ("PVPO"), plant variety rights are rights granted to plant breeders (or owners of the variety) over cultivated plant varieties they have bred or discovered and developed. PVPO provides owners of plant varieties with the legal means to apply for proprietary rights over plant varieties they have bred or discovered and developed. PVPO covers all plants except inedible algae and inedible fungi. A grantee of plant variety right has the exclusive right to produce for sale, offer for sale, sell and import/export reproductive material of the protected variety; to propagate the variety for commercial production of fruit or flowers; and to license others to carry out any of the above activities. Varieties of all types of plants covered by PVPO (e.g. food crops, vegetables, ornamentals) are eligible for protection, subject to certain conditions. A grant under PVPO is in force for a term of 25 years in the case of trees and vines and of 20 years in other cases.

provide that sums received by or accrued to a performer or an organizer 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 would be deemed as receipts arising in or derived from Hong Kong from a trade, profession or business carried on in Hong Kong.

Deduction of expenses for the grant of plant variety rights

7. Clause 4 of the Bill seeks to amend section 16(1)(g) of IRO to allow profits tax deduction for expenditure for the grant of plant variety rights, with effect from a year of assessment beginning on or after 1 April 2018.

Anti-avoidance provisions

8. Clause 6 of the Bill seeks to amend section 16EC(8) of IRO to provide that the existing anti-avoidance measures in relation to tax deduction for capital expenditure for the purchase of the existing five categories of IPRs under the said section would also apply to the three additional categories of IPRs to the effect that tax deduction would not be allowed under certain circumstances.

The Bills Committee

9. At the House Committee meeting on 13 April 2018, Members agreed to form a Bills Committee to study the Bill. The membership list of the Bills Committee is in **Appendix I**. Under the chairmanship of Hon Kenneth LEUNG, the Bills Committee has held two meetings. The Bills Committee has also invited public views on the Bill, and has received a total of 11 written submissions. A list of the organizations that have provided written submissions to the Bills Committee ("deputations") is in **Appendix II**.

Deliberations of the Bills Committee

10. The Bills Committee supports the Bill in principle to expand the scope of profits tax deduction for capital expenditure incurred for the purchase of IPRs to cover the three additional categories of IPRs. The major deliberations of the Bills Committee are set out in the ensuing paragraphs.

Rationale for choosing the three additional categories of intellectual property rights

11. While noting that the current legislative exercise is to give effect to the proposal as announced by FS in the 2016-17 Budget, members have asked about the rationale for choosing the three additional categories of IPRs for inclusion in the scope of profits tax deduction for capital expenditure incurred for the purchase of IPRs.

12. The Administration has advised that the three additional categories of IPRs are covered by the World Trade Organization Agreement on Trade-Related Aspects of Intellectual Property Rights,⁴ and are protected in Hong Kong under respective dedicated IP legislations (i.e. LDTICO, PVPO and CO). The three additional categories of IPRs are, however, not covered by Hong Kong's current regime of profits tax deduction in respect of capital expenditure incurred for the purchase of IPRs. The expansion of the scope of tax deduction for the purchase of IPRs, as explained by the Administration, is one of the measures recommended by the Working Group on IP Trading in March 2015 for promoting Hong Kong as a regional IP trading hub, and the legislative proposal will bring about positive effects to the development of the IP industry in Hong Kong and enhance its status as a premier IP trading hub in Asia.

13. The Administration has also advised that the inclusion of the three additional categories of IPRs will render the scope of profits tax deduction in respect of capital expenditure incurred for the purchase of IPRs under IRO more comprehensive. If the Bill is passed by the Legislative Council ("LegCo"), capital expenditure incurred for the purchase and registration (where applicable under the relevant regimes) of various major categories of IPRs will be deductible under IRO.

Impact on tax revenue

14. In response to members' enquiry on the estimated amount of tax revenue to be forgone pursuant to the proposed profits tax deduction, the Administration has advised that it may not be feasible to arrive at a precise estimation given limited market information and statistics on the

⁴ The Agreement on Trade-Related Aspects of Intellectual Property Rights is an international legal agreement between all the members of the World Trade Organization, which sets out, in respect of each of the main areas of intellectual property covered by the Agreement, the minimum standards of protection to be provided by each member.

trading volume of the three additional categories of IPRs, and the Inland Revenue Department ("IRD") does not have relevant data for estimation because capital expenditure (including the acquisition costs) incurred for the three additional categories of IPRs is not tax deductible at present and therefore no relevant claim has been recorded. As a reference for the Bills Committee's information, the Administration has advised that the total amount of deduction claimed in respect of capital expenditure on the purchase of the existing five categories of tax deductible IPRs for the year of assessment 2015-16 was HK\$846 million.

Conditions for the proposed tax deduction

15. The Bills Committee notes that the proposed tax deduction for the three additional categories of IPRs will be subject to the conditions that are the same as those applicable to the existing five categories of IPRs provided under sections 16E and 16EA of IRO. These conditions include: (a) the taxpayer possesses the legal and the economic ownership⁵ of the relevant IPR; and (b) the IPR has been used by the taxpayer for the production of profits chargeable to tax in Hong Kong. As regards the other condition that IPR should subsist (in the case of copyright) or the registration of IPR be in force (in the case of registered design and registered trade mark) during the basis period of the year of assessment under the tax deduction regime provided in section 16EA(6) of IRO, the Bills Committee notes that clause 5(2) of the Bill seeks to amend the said section to provide similarly that the deduction would only be allowed if the IPR has not expired (in the case of performer's economic right), the protection has not ceased (in the case of the layout-design (topography)) or the grant of the protected right is in force (in the case of plant variety rights).

Scenarios to explain the applicability of the proposed profits tax deduction

16. To facilitate members' understanding of the tax deductions provided under Hong Kong's profits tax regime, the Bills Committee has cited the following scenarios and the Administration has explained applicable tax deductions, as follows:

- (a) a Hong Kong company has spent HK\$1 million on a

⁵ Under section 16EA(13) of the Inland Revenue Ordinance (Cap. 112) ("IRO"), any expenditure incurred on the acquisition of a licence (as defined by section 16EC(8)) of any specified intellectual property right is not deductible under section 16EA.

research and development ("R&D") project in the past five years. An IPR (e.g. patent) is generated from the project and the relevant registration cost is HK\$200,000. The said IPR is held by the company concerned for product manufacturing purpose:

- (i) the Administration has advised that the HK\$1 million R&D expenditure incurred by the company concerned as referred to in (a) above could be tax deductible pursuant to the enhanced tax deduction provided under the Inland Revenue (Amendment) (No. 3) Bill 2018⁶ in respect of qualifying R&D activities. The registration cost of the IPR (e.g. patent) in the amount of HK\$200,000 is tax deductible pursuant to section 16(1)(g) of IRO. Moreover, the production cost of the products manufactured by the company (i.e. stocks) is also tax deductible, while the receipts generated from sale of products is taxable. The Administration has however pointed out that since no sale and purchase of IPR is involved in the above case, the proposed profits tax deduction for the purchase of IPR provided under the Bill is unlikely applicable; and
- (b) a new species of papaya tree is bred by hybrid planting. The papaya seedlings so bred are subsequently sold and the profits generated from the relevant transaction comprise sale of papaya seedlings and transfer of the planting technique of the new species of papaya to the buyer:
 - (i) the Administration has explained that plant variety rights are rights granted to plant breeders (or owners of the variety) over cultivated plant varieties they have bred or discovered and developed. The plant breeders or owners of the variety could apply to the Agriculture, Fisheries and Conservation Department for such proprietary rights pursuant to PVPO. Owners of plant variety rights have exclusive rights to produce reproductive material of the protected variety for the

⁶ The Inland Revenue (Amendment) (No. 3) Bill 2018, which seeks to implement an enhanced tax deduction regime for qualifying research and development activities, is now under the scrutiny of a separate Bills Committee.

purpose of commercial marketing, sell or offer for sale reproductive material of the protected variety, import/export reproductive material of the protected variety, and licence others to carry out the above activities;

- (ii) the Administration has also explained that since IPR is an intangible asset without a physical form, the sale of a registered IPR refers to the transfer of the ownership of and the proprietary rights in relation to the relevant IPR to another party. Royalties or licence fees could not be generated from the relevant IPR by the original owner once it is sold to the other party; and
- (iii) in order to be eligible for registration under the relevant legislation, the plant variety must meet the registration criteria for novelty, distinctness, uniformity and stability. The Administration has advised that the papaya seedlings as referred to in (b) is regarded as a kind of commodity from the perspective of taxation and not an IPR, and thus the proposed profits tax deduction for the purchase of IPRs provided under the Bill is not applicable.

True market value of the intellectual property right

17. The Bills Committee has sought details of the mechanism for determining whether an alleged purchase cost of an IPR is eligible for deduction under the regime of profits tax deduction.

18. The Administration has advised that in determining the true value of the acquisition costs of the relevant IPRs, IRD will make reference to the arm's length principle⁷ and determine real taxable profits. For transactions involving related parties, IRD will take into account relevant transfer pricing provisions, and consider whether the anti-avoidance provisions of IRO will be applicable should the relevant cases demonstrate an intent of tax avoidance or tax evasion.

⁷ The Organisation for Economic Co-operation and Development ("OECD") has adopted the arm's length principle ("ALP") in the OECD Model Tax Convention, to ensure that transfer prices between companies of multinational enterprises are established on a market value basis. In this context, ALP means that prices should be the same as they would have been, had the parties to the transaction not been related to each other.

19. On members' concern over whether there is a possible loophole in the proposed profits tax deduction regime for an enterprise to over-claim the amount of capital expenditure incurred for the purchase of IPRs for tax deduction, the Administration has assured members that IRD has a well-established mechanism to guard against abuses where the claim for tax deduction does not represent the true market value of the IPR at the time of purchase or sale.

Deemed trading receipts

20. As detailed in paragraph 6 above, the Bills Committee notes that section 15 of IRO, if amended by clause 3 of the Bill, seeks to clarify that the scope of sums deemed as taxable receipts arising in or derived from a trade, profession or business carried on in Hong Kong would cover: (a) sums received by or accrued to a person for the use, or the right to the use, of layout-design (topography) of an integrated circuit, performer's right and plant variety right in Hong Kong (or for the use, or the right to use, of such IPRs outside Hong Kong but the sums are deductible in ascertaining the assessable profits of that person) (i.e. clause 3(1) and (2) of the Bill); and (b) sums received by or accrued to a performer or an organizer 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 (i.e. clause 3(3) of the Bill).

21. The Bills Committee notes that some deputations⁸ have made comments on the implementation of the proposed section 15(1)(bb) under clause 3(3) of the Bill. In gist, they have enquired how IRD will conduct tax assessment and tax collection in respect of a non-resident person who is chargeable to tax in respect of sums deemed by the proposed section 15(1)(bb) to be trading receipts arising in or derived from Hong Kong. The deputations have also enquired why the arrangement under the proposed section applies to performers' right only, but not to the other categories of IPRs. Some deputations have further suggested that the sums covered by the proposed section should exclude receipts which are capital in nature, and receipts corresponding to acquisitions for which the expenditure incurred by the assignee are not deductible in Hong Kong.

⁸ The Taxation Institute of Hong Kong, the Association of Hong Kong Accountants, Hong Kong Institute of Certified Public Accountants and PricewaterhouseCoopers Limited.

22. The Administration has explained that the proposed section 15(1)(bb) under clause 3(3) of the Bill is applicable to both Hong Kong residents and non-residents. In case non-residents are involved, IRD has an established mechanism for tax assessment and collection which has been working well over the years. In brief, where section 20B of the IRO applies, the non-resident person concerned (say a non-resident performer/organizer) will be chargeable to tax in respect of the sums concerned in the name of any person in Hong Kong who has paid or credited those sums (say a resident entity) to that or any other non-resident person, and the tax so charged shall be recoverable by all means provided in IRO from that person in Hong Kong. That person in Hong Kong shall, at the time he makes the payment or credit, deduct from those sums so much thereof as is sufficient to produce the amount of such tax. Clause 7 of the Bill proposes to extend the above arrangement to sums deemed to be trading receipts under the proposed section 15(1)(bb).

23. The Bills Committee also notes that notwithstanding the proposed section 15(1)(bb), expenditures incurred by a performer to earn fees from performances or incurred by an organizer to earn fees from arranging or managing performances are eligible for profits tax deduction. Moreover, any further expenditures incurred to produce sums chargeable to tax under the proposed section 15(1)(bb) for an assignment of, or an agreement to assign, a performer's right are also eligible for profits tax deduction.

24. As regards the query on why the arrangement under the proposed section 15(1)(bb) applies to performers' right only, as well as the suggestion of excluding receipts which are capital in nature and those receipts corresponding to acquisitions from the sums covered by the proposed section, the Administration has explained that sums received for an assignment of, or an agreement to assign, a performer's right are trading receipts of a performer. Such sums are no different from the performance fees received by the performer (which are revenue in nature, i.e. chargeable to profits tax) since they are derived directly or indirectly from performances given in Hong Kong. The proposed section 15(1)(bb) stipulates that such sums are trading receipts (which are revenue in nature) that are chargeable to profits tax in Hong Kong. In contrast to a performer's right, in most cases sums received from the sale of other categories of IPRs are capital in nature (not chargeable to profits tax) except for cases where the IPRs are the taxpayers' trading assets.

25. The Administration has also advised that if certain sums are paid to a performer or an organizer in connection with a Hong Kong performance, such sums are deductible under section 16EA of IRO (subject to section 16EC) if the payer is carrying on business in Hong Kong. In any event, as long as the sums received by the recipient are derived from business activities carried out in Hong Kong with a Hong Kong source, such sums should be subject to Hong Kong profits tax. Whether the corresponding payer could successfully obtain tax deduction in Hong Kong under section 16EA is not a relevant factor.

Meaning of "performer's right"

26. The Legal Adviser to the Bills Committee ("Legal Adviser") has raised queries with the Administration on the meaning and scope of "performer's right" as referred to in clause 3(1), (2) and (3) of the Bill. Noting that performer's rights may include performer's economic rights and performer's non-economic rights which have different scopes and nature under CO, the Legal Adviser has requested the Administration to provide clarification on whether the assignment of or an agreement to assign a performer's right (if it is intended to cover the performer's non-economic rights) in relation to a performance given by the performer in Hong Kong under clause 3(3) of the Bill would be in violation of section 224 of CO which provides that performer's non-economic rights (with the exception that they may be passed by testamentary disposition (see section 224(1) and (2) of CO)) are not assignable or transmissible. In reply, the Administration has advised that the term "performer's right" in clause 3(1) and (2) of the Bill includes both performer's "economic rights" (sections 203, 204, 205 and 207A of CO) and "non-economic rights" (sections 202, 206 and 207 of CO) whereas "performer's right" in clause 3(3) of the Bill practically covers performer's "economic rights" only. As performer's economic rights are transmissible by assignment, by testamentary disposition or by operation of law, as personal or moveable property under section 216 of CO whereas performer's non-economic rights are not assignable nor transmissible except by testamentary disposition pursuant to section 224 of CO, the Bills Committee notes that the Legal Adviser has requested the Administration to clarify, given the different scopes and nature of performer's rights as intended to be covered under clause 3(1), (2) and (3) of the Bill respectively, whether and how the use of the same term "performer's right" could be able to reflect the Administration's different policy intent under the said clauses and whether an amendment to clause 3(3) would be needed to better reflect the policy intent.

27. The Administration has further explained that the term "performer's right" includes both economic rights (assignable) and non-economic rights (not assignable). As for "performer's right", it is necessary for clause 3(1) and (2) of the Bill to cover both types of rights, so as to clarify what sums received by or accrued to a person for the use of "performer's right" should be deemed as trading receipts arising in or derived from Hong Kong. In this regard, trading receipts can arise from the use of economic rights, and similarly, from the use of non-economic rights. For example, a performer may receive a sum for the use of his/her non-economic right of making a fixation of his/her performance directly from the unfixed performance. Such sum should be deemed as trading receipts if they meet the other conditions under section 15(1)(b) and (ba) of IRO. Clause 3(3) of the Bill, however, seeks to deal with sums received arising from the assignment (rather than mere use) of performer's rights. Since only economic rights are assignable, clause 3(3) of the Bill will practically cover economic rights only. Taking the words in context, the Administration has pointed out that the reference to "performer's right" in the provision (i.e. "... an assignment of, or an agreement to assign, a performer's right in relation to a performance ...") is clear enough, and should not give rise to any misconception that it covers also non-economic rights.

28. The Administration also considers that by using the same term of "performer's right" in clause 3(1), (2) and (3) of the Bill, it can help highlight the different focuses and natures of the sums involved (i.e. sums arising from use vis-a-vis those arising from assignment) between these sets of provisions in respect of performer's rights, rather than the difference between economic or non-economic rights.

Chinese renditions of the terms "organizer" and "performer"

29. The Bills Committee has considered the appropriateness of the Chinese renditions of the terms "organizer" and "performer" under clause 3(4) of the Bill. Noting that the Chinese rendition of the term "organizer" is "籌辦人" in the Bill, members are concerned that the term "籌辦人" literally refers to a natural person who organizes the performance and may not necessarily reflect the real situation that organizers of performances are in fact mostly companies but not individuals. As such, the Administration has been requested to consider members' suggestion to change the Chinese rendition of "organizer" from "籌辦人" to "籌辦人/機構" to avoid confusion to readers.

30. The Administration has explained that under section 2(1) of IRO, the term "person" (the Chinese rendition of which is "人" or "人士") includes a corporation, partnership, trustee, whether incorporated or unincorporated, or body of persons. As pointed out by the Legal Adviser, the Bills Committee also notes that pursuant to section 3 of the Interpretation and General Clauses Ordinance (Cap. 1) ("IGCO"), the interpretation of the term "person" (the Chinese rendition of which is "人" or "人士") includes any public body and any body of persons, corporate or unincorporate.

31. Members are further concerned that the term "表演者" used as the Chinese rendition of the term "performer" in the Bill may be inconsistent with the above explanation made by the Administration given that the Chinese term "者" may refer to an individual only. The Administration has clarified that the Chinese term concerned is currently used in the provisions of CO. Under section 200 of CO, the term "performer" (the Chinese rendition of which is "表演者") means an actor, singer, musician, dancer or any other person who acts, sings, delivers, declaims, plays in, interprets, or otherwise performs a performance. The Legal Adviser has pointed out that, by virtue of the interpretation provided under section 3 of IGCO, the Chinese term "表演者" also includes any public body and any body of persons, corporate or unincorporate. The Administration has further explained that, in actual situations, the term "表演者" should normally refer to an individual, whereas the term "籌辦人" could refer to either an individual or a company/organization.

32. As the interpretations of the Chinese renditions of the terms "organizer" and "performer" have been clearly provided for under IRO, CO and IGCO respectively, and that the adoption of the terms "籌辦人" and "表演者" as the respective Chinese renditions of the terms "organizer" and "performer" in the Bill can achieve consistency in law drafting, the Administration considers the use of the Chinese terms concerned appropriate.

Anti-avoidance provisions

33. When examining the provisions of clause 6 of the Bill which seeks to amend section 16EC of IRO to provide that the tax deduction is not allowable under certain circumstances, the Bills Committee notes that the existing anti-avoidance measures in relation to tax deduction for capital expenditure for the purchase of the existing five categories of IPRs would also apply to the three additional categories of IPRs. The Bills

Committee also notes that the industrial sector has been appealing to the Administration over the years to amend sections 39E and 16EC of IRO to enable manufacturers to claim tax allowances in respect of the machinery, equipment and IPRs used in their production procedures located outside Hong Kong,⁹ but it is understood by the sector that the Administration has not taken up such proposal on the ground that the proposal may be regarded as encouraging the manufacturers' transfer of company profits via transfer pricing arrangement. Referring to the view expressed by some deputations that the restriction under the existing section 16EC(4)(b) of IRO should be reviewed or removed, some members have enquired whether the Administration would change its stance in respect of the review of sections 39E and 16EC of IRO. The Administration has been urged to take heed of the concerns of the industrial sector and deal with the issue as soon as practicable.

34. The Administration has explained that section 16EC(4)(b) of IRO was introduced in 2011 as an anti-avoidance provision, following similar principles behind section 39E of IRO. The purpose of section 16EC(4)(b) is to deny tax deduction for IPRs which are used outside Hong Kong by a party other than the taxpayer for production of profits not chargeable to tax in Hong Kong. On the issue of section 39E and the related issue of section 16EC, the Administration has reiterated its stance as stated in the reply by the Secretary for Financial Services and the Treasury ("SFST") to an oral question asked at a Council meeting in March 2018¹⁰ that the subject matter is not only concerned with Hong Kong's tax policy, but also the tax arrangements in the Mainland of China.

⁹ Under section 39E(1)(b)(i) of IRO, a taxpayer who incurs capital expenditure on the provision of machinery or plant for the purpose of producing profits chargeable to profits tax shall not have made to him the initial or annual allowances if, at a time when the machinery or plant is owned by the taxpayer, a person holds rights as lessee under a lease of the machinery or plant, and the machinery or plant, not being a ship or aircraft or any part thereof, is while the lease is in force used wholly or principally outside Hong Kong by a person other than the taxpayer.

Under section 16EC(4)(b) of IRO, no deduction is allowable under section 16E or 16EA in respect of any specified IPR purchased by a taxpayer if at a time when the relevant IPR is owned by the taxpayer, a person holds rights as a licensee under a licence of the relevant IPR, and the relevant IPR is, while the licence is in force, used wholly or principally outside Hong Kong by a person other than the taxpayer.

¹⁰ Hon Jimmy NG asked an oral question on "reviewing sections 39E and 16EC of the Inland Revenue Ordinance" at the Council meeting of 21 March 2018.

As set out in the above-mentioned reply given by SFST, in the light of possible economic integration that may be brought about by the development of the Guangdong-Hong Kong-Macao Bay Area, the Administration has communicated with the industry and is re-examining the issue, and will study and explore feasible options that comply with the principles of "tax symmetry" and transfer pricing, etc. The Administration has also explained that the Bill seeks to expand the scope of the existing profits tax deduction to cover the three additional categories of IPRs, and is not an ideal platform for dealing with the issue of section 16EC(4)(b). That said, the views expressed by members and the relevant deputations will be relayed to the Financial Services and the Treasury Bureau to facilitate the study on issues relating to sections 39E and 16EC of IRO.

35. The Bills Committee also notes the suggestion made by some deputations that the existing section 16EC(2) of IRO¹¹ should be removed for the reason that transfer pricing rules will soon be in place in Hong Kong upon enactment of another bill, namely the Inland Revenue (Amendment) (No. 6) Bill 2017 ("the No. 6 Bill").

36. The Administration has explained that the No. 6 Bill, which was introduced into LegCo on 10 January 2018, seeks to, among other things, codify the transfer pricing principles into IRO. It is being examined by another Bills Committee and has yet to be enacted. The transfer pricing provisions in the No. 6 Bill seek to cover the pricing of goods and services between associated enterprises for the purpose of tax computation, whereas section 16EC(2) of IRO was introduced mainly to prevent tax abuses by denying tax deduction of capital expenditure incurred for acquiring IPRs under sale and buyback transactions between associated enterprises (i.e. creation of a non-taxable capital gain with a corresponding deductible capital expenditure). Section 16EC(2), if removed, will create opportunities for abuses. As such, the Administration considers that there are legitimate reasons for retaining section 16EC(2), and has pointed out that an enterprise's revenue expenditure for the use of IPRs (such as royalties and licence fees) is all along deductible under section 16(1) of IRO.

¹¹ Section 16EC(2) of IRO provides that no deduction is allowable under section 16E or 16EA in respect of any specified IPR purchased by a person wholly or partly from an associate.

Proposed amendment to the Bill

37. In response to the Legal Adviser's enquiry, the Administration has proposed a textual amendment to the Chinese text of proposed section 16EA(6)(bb) of IRO under clause 5(2) of the Bill (**Appendix III**), so as to align it with the English text. The Bills Committee agrees to the Administration's proposed amendment and will not propose any amendment to the Bill.

Resumption of Second Reading debate

38. The Bills Committee has no objection to the resumption of the Second Reading debate on the Bill at the Council meeting of 20 June 2018.

Advice sought

39. The Chairman of the Bills Committee made a verbal report on the deliberations of the Bills Committee at the House Committee meeting on 1 June 2018. Members are invited to note the deliberations of the Bills Committee.

Council Business Division 1
Legislative Council Secretariat
7 June 2018

Bills Committee on Inland Revenue (Amendment) (No. 2) Bill 2018

Membership List

Chairman	Hon Kenneth LEUNG
Members	Hon WONG Ting-kwong, GBS, JP
	Hon Paul TSE Wai-chun, JP
	Hon WU Chi-wai, MH
	Hon Charles Peter MOK, JP
	Hon Dennis KWOK Wing-hang
	Hon CHUNG Kwok-pan
	Dr Hon Junius HO Kwan-yiu, JP

(Total : 8 members)

Clerk	Mr Desmond LAM
Legal Adviser	Ms Vanessa CHENG

Bills Committee on Inland Revenue (Amendment) (No. 2) Bill 2018

List of organizations which have provided written submissions

1. Hong Kong Institute of Patent Attorneys Limited
2. Hong Kong Brands Protection Alliance Limited
3. Hong Kong Chinese Patent Attorneys Association
4. Hong Kong & Kowloon Plastic Products Merchants United Association Limited
5. The Taxation Institute of Hong Kong
6. The Association of Hong Kong Accountants
7. Hong Kong Productivity Council
8. Hong Kong Applied Science and Technology Research Institute
9. Association of Chartered Certified Accountants Hong Kong
10. PricewaterhouseCoopers Limited
11. Hong Kong Institute of Certified Public Accountants

Inland Revenue (Amendment) (No. 2) Bill 2018

Committee Stage

Amendment to be moved by the Secretary for Commerce and Economic Development

Clause

Amendment Proposed

- 5(2) In the proposed section 16EA(6)(bb), in the Chinese text, by deleting “(拓樸圖)權利仍” and substituting “仍”.