# 修訂稅務條例
# 第39E及16EC條
# 建議報告

**Suggestions to Amend Sections 39E and 16EC of the Inland Revenue Ordinance**

# Contents

# 1 Abbreviations used in the report

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| ACCA | Association of Chartered Certified Accountants |
| B&R Initiative | Belt and Road Initiative |
| Consultation Report | Transfer pricing report issued by the Hong Kong Government on 31 July 2017 |
| DIPN | Departmental Interpretation and Practice Notes |
| Equipment | Plant and machinery |
| FSTB | Financial Services and the Treasury Bureau |
| HKICPA | The Hong Kong Institute of Certified Public Accountants |
| IRD | Inland Revenue Department |
| IRO | Inland Revenue Ordinance |
| IPRs | Intellectual property rights |
| I&T | Innovation and technology |
| TP | Transfer pricing |

# 2 Objective of this report

It has been a long recurring issue since the early 2000s within the business community that Hong Kong enterprises who incur capital expenditure for the acquisition of equipment are denied depreciation allowances when the assets are made available to factories or other outsourced manufacturers in the Mainland under import processing arrangements (進料加工). The IRD has taken the position that Section 39E of the IRO, which is an anti-avoidance provision, applies to such arrangements and therefore denies depreciation allowance claims.

The IRD's position has created numerous disputes with taxpayers and has increased the operating costs of Hong Kong enterprises who engage in offshore manufacturing. The profits of such enterprises are fully taxable for Profits Tax purposes; whilst the expenditure incurred on necessary equipment (which represents a major cost) is denied any tax relief.

A similar problem arises in respect of IPRs. As an incentive to step up technological innovation in local industries and promote wider application of IPRs by local enterprises, the Financial Secretary proposed in the 2010/11 Budget to extend the deduction for capital expenditure on IPRs to cover such items as copyrights, registered designs and registered trademarks under Section 16EA. This was in addition to the deduction that was already available for the purchase costs of patent and know-how rights under Section 16E.

Similarly to Section 39E, an anti-avoidance provision (Section 16EC) was introduced at the same time to deny a deduction for the cost of an IPR if the IPR was used wholly or principally outside Hong Kong by persons other than the Hong Kong owner.

In the 2017/18 Budget, the Financial Secretary announced that I&T was to become a new engine to power the sustainable and diversified economic development of Hong Kong. He noted that Hong Kong had experienced economic restructuring in recent years with the result that the contribution of the manufacturing industry to the economy had declined considerably since the early 2000s. The Government therefore adopted a policy whereby I&T would drive Hong Kong's re-industrialisation to facilitate the development of a high-end manufacturing industry in Hong Kong, which in turn would promote economic growth and create quality jobs.

The establishment of the Innovation and Technology Bureau in November 2015 was a key step in developing the I&T ecosystem in Hong Kong. In the 2017/18 Budget, the Financial Secretary also announced that a new committee on I&T development and re-industrialisation would be set up to co-ordinate the planned development. As part of this initiative, the Tax Policy Unit to be established within the FSTB would explore enhanced tax deductions for I&T expenditure.

While these developments with respect to I&T are positive steps to improve the competencies of local I&T enterprises under the re-industrialisation initiative, the existing limitations in Sections 39E and 16EC continue to undermine manufacturers' ability to expand their businesses by developing their manufacturing capabilities outside Hong Kong under the B&R Initiative. The denial of depreciation allowances under Section 39E and IPRs deductions under Section 16EC significantly increases their operating costs and limits their growth potential under the re-industrialisation initiative.

We set out in this report the relevant technical analyses, our observations on the IRD's interpretation and practice, as well as our suggestions for legislative changes to Sections 39E and 16EC of the IRO. We hope these will help to enable the relevant stakeholders including the government to discuss these issues and take this matter forward.

# 3 Brief history of Section 39E

Section 39E of the IRO was introduced in 1986 with the legislative intention of limiting opportunities for tax deferral and avoidance through sales and leasebacks of equipment (and through leveraged leasing arrangements)[1]. Where the section applies, an owner of equipment will be denied depreciation allowances (i.e. initial allowances and annual allowances) in respect of its purchase price.

When Section 39E was scrutinised and passed by the Legislative Council in 1986, the Hong Kong Government stated that the provision was intended to only strike down cases of tax avoidance under sale and leaseback (and leveraged leasing) arrangements. At the same time, the Government gave an assurance that general leasing transactions and normal commercial transactions would not be affected.

Notwithstanding this legislative intention and assurance, the IRD has taken the position since the early 2000s of denying depreciation allowance claims where a Hong Kong enterprise makes the relevant equipment available for use by factories or outsourced manufacturers in the Mainland under ordinary commercial arrangements (e.g. import processing arrangements). This was the case even if (i) the Hong Kong enterprise did not engage in any tax deferral or avoidance arrangement (through a sale and leaseback or leveraged leasing arrangements or other avoidance device), and (ii) the profits derived by the Hong Kong enterprise were fully subject to Profits Tax in Hong Kong.

Under the IRO, taxpayers are provided with tax relief for equipment costs as follows:-

- 100% outright deduction under Section 16G[2] of the IRO. However, this deduction does not apply if the plant or machinery is subject to a ***lease***; or
- depreciation allowances (initial allowance at 60% in the year the expenditure is incurred plus annual allowances at 10%, 20% or 30% on the tax written down value). However, depreciation allowances (both initial and annual allowances) do not apply under Section 39E(1) of the IRO if the equipment (not being a ship or an aircraft) is subject to a ***lease*** and is used wholly or principally outside Hong Kong.

The key issues under Sections 16G and 39E is whether the equipment is considered to be subject to a ***lease***. In general parlance, the word "lease" is not appropriate to describe the arrangement whereby a Hong Kong manufacturer makes equipment available to Mainland factories. However, Section 39E contains a statutory definition of "lease" which has given rise to the difficulties being faced by manufacturers.

## 3.1 Definition of "lease" under the IRO

Section 2 of the IRO defines a "lease" in respect of plant and machinery to include:-

(a) any arrangement under which a right to use the equipment is granted by the owner of the equipment to another person; and

[1] The relevant Budget Speech is enclosed as **Appendix 1**.
[2] As an incentive to invest more in high value manufacturing and modern business systems, in his 1998/99 Budget Speech, the then Financial Secretary proposed an immediate 100% write-off for new expenditure on plant and machinery specifically related to manufacturing plant and machinery, computer hardware and software. This proposal was subsequently approved and the relevant legislation was enacted under Section 16G of the IRO effective from the year of assessment 1998/99.

(b) any arrangement under which a right to use the equipment, being a right derived directly or indirectly from a right referred to in paragraph (a), is granted by another person, but does not include a hire-purchase agreement or a conditional sale agreement unless, in the opinion of the Commissioner, the right under the agreement to purchase or obtain the property in the goods would reasonably be expected not to be exercised.

The main concern is item (a) above which is a very broad definition. The IRD took the position that, irrespective of whether or not rent is charged, the grant of a right to use equipment to any other party constitutes a "lease". Hence, it applied Section 39E to taxpayers who made equipment available to Mainland factories for the purposes of assisting their production of the relevant goods. This was clearly not a case of tax avoidance and appeared to be inconsistent with the legislative intention behind Section 39E which was to attack only cases of tax avoidance involving sale and leaseback arrangements and leveraged leasing arrangements. Applying Section 39E to cases involving consignments by manufacturers to factories of equipment was inconsistent with the original legislative intention.

The IRD indicated its position in its 2006 and 2007 annual meetings with the HKICPA and in its DIPN[3] No. 15. Extracts from these meeting minutes and DIPN are enclosed as **Appendices 2 to 4**.

Because Section 39E is expressed in wide terms and literally applies to such consignment arrangements between manufacturers and Mainland factories, the hands of the courts were tied in subsequent litigation. The courts (including the Court of Final Appeal) therefore had no choice but to uphold the IRD's position in cases before them.

## 3.2 The undesirable tax consequences

The current operation of Section 39E has resulted in adverse impact to various businesses. There were numerous disputes between the IRD and taxpayers regarding depreciation allowance claims on plant and machinery provided by Hong Kong companies to Mainland subcontractors on a rent-free basis under import processing arrangements.

To illustrate the undesirable tax consequences of Section 39E (which are inconsistent with the original legislative intent behind the section), we set out an example of a typical manufacturing business scenario where the IRD will deny depreciation allowance claims with respect to equipment pursuant to Section 39E.

- Many Hong Kong manufacturers have relocated their manufacturing operations to the Mainland, but they remain active in Hong Kong by operating local offices. These Hong Kong companies operate as trading companies, but also provide substantial support to the manufacturing operations carried out in the Mainland;

- Hong Kong enterprises often structure their relationships with factories in the Mainland in the form of contract manufacturing, namely contract processing (來料加工) and import processing (進料加工) arrangements. Under these arrangements, the Hong Kong enterprise typically enters into a contract with a local factory in the Mainland for the production of goods. The Hong Kong enterprise sources raw materials, provides product design and

[3] DIPNs contain the IRD's interpretation and practices in relation to the law as it stood at the date of publication. They have no legally binding effect to either the IRD or the taxpayers. With that said, we notice that the IRD generally adheres to the positions stated in DIPNs.

technical know-how, and provides plant and machinery (e.g. moulds) to the Mainland factory.

- The Mainland factory produces the finished goods for the Hong Kong enterprise to sell into overseas markets;

    - Under a contract processing (來料加工) arrangement, legal title to the raw materials and finished goods remains with the Hong Kong enterprise at all times;

    - Under an import processing (進料加工) arrangement, the Hong Kong enterprise sells the raw materials to the Mainland factory.

- After import processing, the Mainland factory will sell the finished goods to the Hong Kong manufacturer. After contract processing, the goods automatically belong to the Hong Kong enterprise.

- Broadly speaking, the change of legal title to the raw materials and finished goods is the major difference between a contract processing and an import processing arrangement. That said, for all practical purposes, the roles played by the Hong Kong enterprises under these arrangements are very similar. In both cases, they provide all the plant and machinery free of charge, as well as substantial operational and administrative support, to the Mainland factories in the manufacturing process.

- For certain industries, given the proprietary nature of product designs, it is very common for Hong Kong companies to supply the necessary moulds to its overseas vendors. The moulds are usually used solely for the production of products that belong to (or are sold to) the Hong Kong enterprises. This mould loan arrangement is in place irrespective of whether a processing trade is involved.

  Because the relevant mould costs are not included as part of the processing factories' cost base, the processing fees charged by the factories to the Hong Kong companies would generally be lower than would otherwise be the case. However, this is because the Hong Kong enterprise is required to bear the cost of providing the mould.

- Because of the IRD's application of Section 39E, the Hong Kong enterprise is not entitled to **<u>any</u>** tax relief for its cost of providing the mould to the factory (other than for enterprises engaging in contract processing arrangements to which the IRD allows a concessionary 50% claim for the depreciation allowances[4]).

Considering capital expenditure for plant and machinery is a key cost component for most manufacturers, Section 39E has a hugely adverse impact on Hong Kong enterprises who engage in such activities.

[4] For Hong Kong manufacturers engaging in contract processing (來料加工) arrangements, the IRD is of the view that the Hong Kong manufacturers have operations in the Mainland factory such that they are regarded as using the plant and machinery there. Accordingly, Section 39E of the IRO had not been strictly applied in this context whereby the Hong Kong manufacturers are allowed as a concession to claim 50% of the relevant depreciation allowances as their profits are treated as 50% taxable (see **Appendix 5** for the relevant extract of minutes for the 2009 annual meeting between the IRD and HKICPA).

# 4 Brief history of Sections 16E, 16EA and 16EC

As an incentive to step up technological innovation in local industries, Section 16E of the IRO was introduced in 1983 to provide a deduction for the capital cost of acquiring patents, trademarks and designs. As a result of subsequent amendments, the current position is that only the purchase cost of ***patent rights*** and ***rights to any know-how*** are deductible under Section 16E.

To promote wider investment in IPRs by local enterprises and to facilitate the development of creative industries in Hong Kong, the Financial Secretary proposed in the 2010/11 Budget Speech that Profits Tax deductions should be extended to cover capital expenditure on the purchase of three types of commonly-used IPRs, namely, ***copyrights***, ***registered designs*** and ***registered trademarks***. As a result, Section 16EA of the IRO was enacted in December 2011.

Section 16EC(4)(b) of the IRO, an anti-avoidance provision, was introduced at the same time to prevent potential exploitation of the IPR deduction. A deduction is denied if an IPR is ***used*** wholly or principally outside Hong Kong by persons other than the taxpayer who owns the IPR.

## 4.1 The IRD's interpretation of Section 16EC

The IRD issued DIPN No. 49 in July 2012 setting out its interpretation of the provisions relating to the (i) deduction of capital expenditure on IPRs; and (ii) taxation of royalties derived from licensing of IPRs. In the DIPN, the IRD states that it is prepared to adopt a pragmatic approach in applying Section 16EC(4)(b) considering the peculiar nature of IPRs, the territorial registration system, the protection of the rights and the wide scope by which the IPRs can be used.

DIPN 49 sets out various examples which illustrate the circumstances in which the IRD will or will not apply Section 16EC(4)(b) to deny a deduction under Sections 16E or 16EA of the IRO. Based on these examples, if a taxpayer (i) incurs capital expenditure on the purchase of trademarks registered **outside** Hong Kong; and (ii) the relevant trademarks are used by a non-Hong Kong contract manufacturer for the production of goods outside Hong Kong, the purchase price will be non-deductible, even if all the profits of the taxpayer are taxable in Hong Kong.

## 4.2 The undesirable tax consequences

Unlike Section 39E, the concept of a "lease" is not relevant in the context of deductions for IPRs. Nevertheless, similar undesirable tax consequences arise in both cases where the (leased) equipment or the overseas registered IPRs are used outside Hong Kong by someone other than the taxpayer who owns the equipment or IPR. Specifically, Hong Kong enterprises who (i) purchase IPRs registered outside Hong Kong; and (ii) sub-contract production work to factories located outside Hong Kong which exploit the overseas registered IPRs in the manufacturing process will be denied a tax deduction for the relevant capital expenditure on the overseas registered IPRs, even though all the profits derived by the enterprise are fully taxable in Hong Kong.

# 5 Practical observations on Sections 39E and 16EC

## 5.1 Section 39E

In many cases, the IRD has refused deductions where equipment was made available by a Hong Kong taxpayer to a Mainland factory under an import processing arrangement, even in cases where the equipment was recorded as a fixed asset in the Hong Kong taxpayer's books, where the equipment was in fact wholly used by the Mainland factory. The IRD justified its position by asserting that such a scenario potentially gives rise to tax depreciation claims in both Hong Kong (by the Hong Kong taxpayer) and China (by the Mainland factory – which in our view should not be the case) on the capital expenditure incurred on the same piece of equipment.

The IRD initiated numerous field audit cases against Hong Kong taxpayers who were engaged in processing arrangements, with a particular focus on their tax depreciation allowance claims. From the business community's standpoint, this is unfair. The provision of equipment to Mainland factories under import processing arrangements is commercially driven and does not involve any tax avoidance motive (and in fact is no different from the provision of equipment under contract processing arrangements). As a result, there were many disagreements between the IRD and the taxpayers on the interpretation of "lease" and the application of Section 39E under the IRO.

Hong Kong taxpayers typically put forward the following arguments to pursue their claims for deductions and depreciation allowances in cases involving import processing arrangements.

- The equipment was provided by the Hong Kong enterprise to the Mainland factory pursuant to genuine commercial arrangements without any tax avoidance motive.

- The equipment was at all times owned by the Hong Kong enterprise, and was not injected into the Mainland factory as a capital contribution.

- The Mainland factory was not subject to tax in Hong Kong. Therefore, it was not possible for any other entity besides the Hong Kong taxpayer to claim tax allowances in Hong Kong in respect of the same item of equipment, and hence there would not be any loss of tax revenue to Hong Kong.

- The Hong Kong enterprise was merely claiming tax benefits that rightfully accrued to it in connection with its capital expenditure on equipment used exclusively for the production of its profits which were fully taxable in Hong Kong.

- The Mainland factory was not claiming any tax depreciation allowances in respect of the equipment provided by the Hong Kong enterprise. If a factory did so, this would be incorrect from both PRC accounting and tax perspectives. The Hong Kong enterprise should not be punished if the factory was indeed taking such an incorrect position.

- There was no attempt by the Hong Kong enterprise to exploit provisions contained in the IRO or seek to benefit from any tax deferral or tax avoidance opportunity.

Despite these arguments, the IRD continued to refuse Hong Kong taxpayers who engaged in non-contract processing arrangements outright deductions under Section 16G of the IRO and depreciation allowances under Section 39E of the IRO.

We are aware that some businesses have chosen to relocate to Singapore or Ireland in preference to Hong Kong largely because of the denial of tax depreciation allowances under Section 39E. These cases included activities relating to container leasing and asset based financing (aircraft leasing). As a result, operating lease financing activities were no longer structured through Hong Kong but through other locations, notably Ireland and Singapore. This represented a lost opportunity for Hong Kong to develop as a transport and logistics hub which is supposedly one of Hong Kong's "pillar industries". (More recent amendments to the IRO have introduced new tax incentives to make Hong Kong a favourable centre for aircraft operating leasing activities.)

The unsatisfactory nature of the current position is well known to the IRD. The IRD attempted to mitigate some of the harshness of these provisions with a statement made in the example set out in Paragraph 17 of DIPN No. 15. This provides that where, Section 39E(1)(b)(i) of the IRO denies depreciation allowances where equipment is used by a third party wholly outside Hong Kong, the lease income would, **as a practice**, be regarded as non-taxable. While commendable as an attempt to remedy some of the concerns, this is unsatisfactory because there is no legislative basis for treating income as non-taxable solely because deductions are being denied. In addition, DIPNs do not have any legally binding effect, so the IRD can refuse to apply this so-called practice in cases where it wishes to tax the leasing income. Hence, this example does not sufficiently address the issues of concern.

In any event, a Hong Kong manufacturer who consigns equipment to a Mainland factory does not charge rent to the factory. Hence, this concession is not relevant to a Hong Kong manufacturer.

## 5.2 Section 16EC

Before Section 16EC was enacted in December 2011, the ACCA made a submission dated 29 March 2011 (see **Appendix 6**) to the then Legislative Councillor (Accountancy), Hon Paul CHAN Mo-po, MH, JP, about its concern that the proposal would not be able to serve the purpose of "to promote the wider application of intellectual property by enterprises and the development of creative industries", and would cause concerns similar to those arising as a result of Section 39E. ACCA highlighted that, in the case of a taxpayer producing goods through sub-contractors outside Hong Kong using IPRs, Section 16EC(4)(b) would disallow a deduction for the cost of the IPRs on the ground that they were not being used by the owner but by the sub-contractor (under license) outside Hong Kong.

In response to ACCA, the FSTB issued a letter dated 6 April 2011 (see **Appendix 7**) explaining that, where a Hong Kong enterprise allows its overseas sub-contractor to use outside Hong Kong an IPR owned by the Hong Kong enterprise at no cost, the overseas production activities by the sub-contractor are generally not attributed to the Hong Kong enterprise. Accordingly, the IRD would not charge Profits Tax on the sub-contractor nor on the Hong Kong enterprise for the overseas production activities, by application of the "territorial source" principle.

The FSTB emphasised that, if it recognised the "no cost" arrangement for the use of IPRs outside Hong Kong and granted a tax deduction, the relevant overseas jurisdiction could query whether Hong Kong was violating established TP principles by not applying the "arm's length principle" advocated by the OECD and thus prejudicing the taxing rights of the overseas jurisdiction concerned.

When the Bills Committee in the Legislative Council deliberated the proposal (see **Appendix 8** for the Bills Committee report), there were a number of deputations who raised concerns about, and objected to, the proposed Section 16EC(4)(b). Their point was that it would result in a blanket denial of tax deductions for businesses engaged in cross-border activities involving the use of IPRs by a party other than the taxpayer, even where the relevant IPR was being used (outside Hong Kong) to produce goods to be sold solely to the taxpayer. Despite these concerns, the Government continued to insist that Section 16EC(4)(b) should be enacted, and LegCo ultimately endorsed the Government's position.

As a result, in practice, Hong Kong taxpayers cannot claim the benefits of Sections 16E / 16EA of the IRO when they incur capital expenditure on the acquisition of IPRs.

In a global economy where innovation and application of technology are no longer limited to any particular jurisdiction, limiting the deductibility of purchase costs for IPRs registered outside Hong Kong, especially in cases where the resulting profits are fully taxable in Hong Kong, creates a disparity in terms of the "tax symmetry" principle of matching revenue and costs of a taxpayer for the purpose of computing net taxable income. It also undercuts the Government's stated strategy of promoting Hong Kong as an intellectual property trading hub by disincentivising investment in IPRs.

The Government has an apparent initiative to promote I&T and re-industrialisation in Hong Kong, as evidenced by the recent announcement of a new tax incentive comprising enhanced tax deductions for I&T expenditure. The limitation on tax relief for expenditure on IPRs deduction under Section 16EC(4)(b) weakens this initiative and should be properly examined and addressed.

# 6 Arguments for amending Sections 39E and 16EC

Numerous parties have raised concerns about the unintended negative effects of Sections 39E and 16EC via different means over the years. The Hong Kong Government and the IRD have refused to consider legislative changes or adopt a more liberal approach in interpreting these provisions, even in cases of genuine commercial transactions involving no tax avoidance motive.

Despite the long standing position of the Hong Kong Government and the IRD, the recent developments under the B&R Initiative, the new aircraft leasing regime in Hong Kong and the coming introduction of comprehensive TP legislation, as well as the practical concerns and difficulties faced by the business community, combine to present an opportunity to revisit the possibility of lobbying for the introduction of legislative changes to Sections 39E and 16EC with the Government, the IRD and the newly-formed Tax Policy Unit within the FSTB.

We set out proposals below to amend Sections 39E and 16EC. We look forward to more in-depth discussions among the stakeholders to develop the arguments for these amendments further and to buttress them with appropriate statistics and estimates.

## 6.1 Section 39E: Amend the definition of "lease"

For Hong Kong manufacturers wrestling with Section 39E, the main problem is the broad definition of "lease" under Section 2 of the IRO. The statutory definition is so broad that it includes all situations where equipment is provided to another party, irrespective of whether or not rent is charged.

To rectify this problem, we suggest the definition of "lease" under Section 2 should be amended so that it does not apply in cases where equipment is provided by a Hong Kong taxpayer to a supplier to assist the supplier to produce goods for sale to the Hong Kong taxpayer or to the order of the Hong Kong taxpayer. The definition should be confined to cases involving a "normal" lease in consideration of rental income.

For example, we suggest that the definition of "lease" under Section 2 could be amended as follows:-

*"lease, in relation to any machinery or plant, includes:-*

*……*

*but does not include:-*

*(a) a hire-purchase agreement or conditional sale…..; and*

*(b) any arrangement under which a right to use the machinery or plant is granted by the owner of the machinery or plant to another person, who is engaged by the owner of the machinery or plant to manufacture goods for the owner of the machinery or plant, and the said machinery or plant is used by such another person solely for manufacturing goods for sale to the owner of the machinery or plant, or to the order of the owner of the machinery or plant."*

## 6.2 Section 16EC: Limit the concept of "use"

For Hong Kong manufacturers wrestling with Section 16EC(4)(b), the problem is the use by persons outside Hong Kong of the relevant IPR, irrespective of whether a royalty or other license fee is charged.

To avoid this problem, we suggest that Section 16EC(4)(b) be amended so that it does not apply in cases where IPR is provided by a Hong Kong taxpayer to a supplier to assist the supplier to produce goods for sale to the Hong Kong taxpayer or to the order of the Hong Kong taxpayer. The concept of "use" should be confined to cases involving a "normal" licensing agreement in consideration of royalty income.

For example, we suggest that Section 16EC(4)(b) could be amended as follows:-

*"the relevant right is, while the licence is in force, used wholly and principally outside Hong Kong by a person other than the taxpayer, except where the relevant right is used by a person other than the taxpayer who is engaged by the taxpayer to use such right to manufacture goods solely for sale to the taxpayer or to the order of the taxpayer."*

## 6.3 The introduction of comprehensive TP legislation

Following a public consultation exercise, the Hong Kong Government issued the Consultation Report[5] which indicated that it would seek to enact amendments to the IRO to implement a comprehensive TP regime in Hong Kong. The legislation is expected to be introduced into LegCo in early 2018.

The introduction of comprehensive TP rules in Hong Kong provides a basis to reopen discussions with the Government about amending Sections 39E and 16EC. This is because (as explained in part 4.2 above), the Government previously sought to justify its hard-line position by referring to TP concerns if the IRD were to relax its position under those sections. The introduction of a formal comprehensive TP regime means that any TP concerns and potential abuses can now be met by applying the new TP rules, in which case the strict position taken by the IRD under Sections 39E and 16EC can now be relaxed.

Specifically, from a TP perspective, transactions between related companies should be carried out on an arm's length basis, and the profits of related entities should be ascertained depending on the economic benefits, risks and functions assumed by them under the relevant transactions.

In the typical example of a Hong Kong taxpayer having ownership of equipment and/or IPRs which are provided to a contract manufacturer on the Mainland to use in its manufacturing processes, the Hong Kong taxpayer generally assumes the role of a principal in the integrated value chain, while the factory outside Hong Kong generally assumes the role of a limited risk contractor in producing the requisite products according to the specifications and instructions provided by the Hong Kong taxpayer. In most cases, the processing factory outside Hong Kong depends heavily on the Hong Kong taxpayer to provide equipment and IPRs for use in the production process.

[5] The three-tier documentation requirement consisting of TP master file, local file and County by Country "CbyC report" provides the tax authorities with a risk assessment platform with greater visibility of taxpayers' global arrangements and help them to identify targets for tax and TP audits. The Consultation Report has specified the thresholds for triggering the preparation of master file and local file. Please refer to **Appendix 9** a publication issued by KPMG summarizing the key areas set out in the Consultation Report.

As a principal, the Hong Kong taxpayer bears most of the trading risks and undertakes most of the activities attributable to value creation in the value chain. For instance, the Hong Kong principal performs sales and marketing activities in identifying customers and securing orders, identifies the appropriate processing factories to assist with the production, and provides them with equipment and IPRs for no fee.

As a limited risk contractor, the processing factory outside Hong Kong generally provides the plant facilities and labour in producing the goods based on the specifications and instructions provided by the Hong Kong principal.

From a TP perspective, under this function and risk profile, the commercial value from the value chain cannot be realised and materialised without the principal's (i.e. the Hong Kong manufacturer's) activities and input (e.g. equipment and IPRs) The factory alone would not be able to realise the same value. For this reason, the principal, from a TP perspective, should presumably enjoy the residual profits from the entire value chain, whilst the limited risk contractor should only be entitled to a routine level of profits which remunerate its limited risks and functions. The level of profits calculated by adopting this approach should result in a reasonable level of profits being reported by the Hong Kong taxpayer for Profits Tax purposes.

Under the tax symmetry principle, the Hong Kong taxpayer, being the owner of the relevant equipment and IPRs and who has incurred the relevant capital expenditure, should be entitled to claim the corresponding tax deductions and capital allowances whether or not relevant equipment or IPRs is used by the factory outside Hong Kong. Under TP principles, the profits derived by the Hong Kong taxpayer will already have been calculated by taking into account the provision by the taxpayer of any equipment and IPR to the factory outside Hong Kong.

## 6.4 Commercial considerations when expanding business overseas

Under the B&R Initiative, the Hong Kong business community is being encouraged to set up business in the 60+ economies along the Belt & Road. While the business community embraces the opportunity and the drive for deeper regional development under the B&R Initiative, Hong Kong businesses will have reservations about investing in equipment and IPRs when deciding whether to establish factories or other production plants in those countries, in view of the unfavourable tax treatment that would apply if they incur expenditure on equipment and IPRs to be provided to overseas factories.

In addition, we would note that, for various reasons, principally related to protection of ownership rights in respect of equipment and intellectual property rights in respect of IPRs, Hong Kong taxpayers understandably prefer to retain ownership of their equipment and IPRs where they intend to subcontract manufacturing activities to a factory.

Finally, it is worth noting that, in some cases, if manufacturing equipment and IPRs were not provided free of charge to the overseas factories, from a practical standpoint, companies engaged in offshore manufacturing face difficulties in receiving remittances of rental income and royalties from certain overseas jurisdictions due to their foreign exchange control regulations.

## OFFICIAL REPORT OF PROCEEDINGS

**Wednesday, 27 February 1985**

**The Council met at half past two o'clock**

**PRESENT**

HIS EXCELLENCY THE GOVERNOR (*PRESIDENT*)
SIR EDWARD YOUDE, G.C.M.G., M.B.E.

THE HONOURABLE THE CHIEF SECRETARY (*Acting*)
MR. DAVID AKERS-JONES, C.M.G., J.P.

THE HONOURABLE THE FINANCIAL SECRETARY
SIR JOHN HENRY BREMRIDGE, K.B.E., J.P.

THE HONOURABLE THE ATTORNEY GENERAL
MR. MICHAEL DAVID THOMAS, C.M.G., Q.C.

THE HONOURABLE SIR ROGERIO HYNDMAN LOBO, C.B.E., J.P.

DR. THE HONOURABLE HARRY FANG SIN-YANG, C.B.E., J.P.

THE HONOURABLE FRANCIS YUAN-HAO TIEN, O.B.E., J.P.

THE HONOURABLE ALEX WU SHU-CHIH, C.B.E., J.P.

THE HONOURABLE CHEN SHOU-LUM, C.B.E., J.P.

THE HONOURABLE LYDIA DUNN, C.B.E., J.P.

THE HONOURABLE PETER C. WONG, O.B.E., J.P.

THE HONOURABLE WONG LAM, O.B.E., J.P.

DR. THE HONOURABLE THONG KAH-LEONG, C.B.E., J.P.
DIRECTOR OF MEDICAL AND HEALTH SERVICES

THE HONOURABLE ERIC PETER HO, C.B.E., J.P.
SECRETARY FOR TRADE AND INDUSTRY

DR. THE HONOURABLE HO KAM-FAI, O.B.E., J.P.

THE HONOURABLE ALLEN LEE PENG-FEI, O.B.E., J.P.

THE HONOURABLE ANDREW SO KWOK-WING, O.B.E., J.P.

THE HONOURABLE HU FA-KUANG, O.B.E., J.P.

THE HONOURABLE WONG PO-YAN, O.B.E., J.P.

THE HONOURABLE DONALD LIAO POON-HUAI, C.B.E., J.P.
SECRETARY FOR DISTRICT ADMINISTRATION

THE HONOURABLE WILLIAM CHARLES LANGDON BROWN, O.B.E., J.P.

THE HONOURABLE CHAN KAM-CHUEN, O.B.E., J.P.

THE HONOURABLE JOHN JOSEPH SWAINE, O.B.E., Q.C., J.P.

THE HONOURABLE STEPHEN CHEONG KAM-CHUEN, O.B.E., J.P.

THE HONOURABLE CHEUNG YAN-LUNG, M.B.E., J.P.

THE HONOURABLE MRS. SELINA CHOW LIANG SHUK-YEE, J.P.

THE HONOURABLE MARIA TAM WAI-CHU, O.B.E., J.P.

DR. THE HONOURABLE HENRIETTA IP MAN-HING

THE HONOURABLE PIERS JACOBS, O.B.E., J.P.
SECRETARY FOR ECONOMIC SERVICES

THE HONOURABLE DAVID GREGORY JEAFFRESON, C.B.E., J.P.
SECRETARY FOR SECURITY

THE HONOURABLE CHAN NAI-KEONG, C.B.E., J.P.
SECRETARY FOR LANDS AND WORKS

THE HONOURABLE RONALD GEORGE BLACKER BRIDGE, J.P.
COMMISSIONER FOR LABOUR

THE HONOURABLE CHAN YING-LUN

THE HONOURABLE MRS. RITA FAN HSU LAI-TAI

THE HONOURABLE MRS. PAULINE NG CHOW MAY-LIN

THE HONOURABLE PETER POON WING-CHEUNG, M.B.E., J.P.

THE HONOURABLE YEUNG PO-KWAN, C.P.M.

THE HONOURABLE JAMES NEIL HENDERSON, O.B.E., J.P.
SECRETARY FOR EDUCATION AND MANPOWER

THE HONOURABLE KIM CHAM YAU-SUM, J.P.

THE HONOURABLE KEITH LAM HON-KEUNG, J.P.

THE HONOURABLE CARL TONG KA-WING

THE HONOURABLE JOHN WALTER CHAMBERS, J.P.
SECRETARY FOR HEALTH AND WELFARE

THE HONOURABLE MICHAEL LEUNG MAN-KIN, J.P.
DIRECTOR OF EDUCATION

THE HONOURABLE PETER TSAO KWANG-YUNG, C.P.M., J.P.
SECRETARY FOR HOME AFFAIRS

THE HONOURABLE DAVID ROBERT FORD, L.V.O., O.B.E., J.P.
SECRETARY FOR HOUSING

THE HONOURABLE IAN FRANCIS CLUNY MACPHERSON, O.B.E., J.P.
SECRETARY FOR TRANSPORT

**IN ATTENDANCE**

THE CLERK TO THE LEGISLATIVE COUNCIL
MR. LI WING

## Papers

The following papers were laid pursuant to Standing Order 14(2):—

| *Subject* | ***L.N. No.*** |
|---|---|
| Subsidiary Legislation: | |
| Kowloon-Canton Railway By-Laws. | |
| Kowloon-Canton Railway (Restricted Area) Notice 1985 | 25 |
| Port Control (Cargo Working Areas) Ordinance. | |
| Port Control (Public Water-Front) Order 1985 | 26 |
| Road Traffic Ordinance. | |
| Road Traffic (Parking) (Amendment) Regulations 1985 | 27 |
| Shipping and Port Control Ordinance. | |
| Shipping and Port Control Ordinance (Exemption) Notice 1985 | 28 |
| Shipping and Port Control Regulations. | |
| Shipping and Port Control Regulations (Amendment of Eighth Schedule) Notice 1985 | 29 |
| Public Health and Urban Service Ordinance. | |
| Public Health and Urban Services (Public Markets) (Designation and Amendment of Tenth Schedule) Order 1985 | 30 |
| Public Health and Urban Services Ordinance. | |
| Declaration of Markets in the Urban Areas | 31 |

Sessional Papers 1984-85:

No. 44—Draft Estimates for the year ending 31 March 1986— Volume 1 Expenditure.

No. 45—Draft Estimates for the year ending 31 March 1986— Volume 2 Revenue, Funds and Statistical Appendices.

No. 46—Report of the Public Works Sub-Committee of Finance Committee 1984-85.

No. 47—Report of the Establishment Sub-Committee of Finance Committee for 1984-85.

## Valedictory to MR. T. S. Lo

HIS EXCELLENCY THE PRESIDENT:—Honourable Members, since we last met, Mr. T. S. Lo has resigned from this Council, on which he served for more than ten years from 1974. These have been particularly busy years in the life of this

Council, especially during the past two years, and I would like to pay tribute to the valuable service he has rendered, not only in this Council but in a number of public bodies.

I am sure Members would wish to join me in wishing Mr. Lo well in the future.

SIR ROGER LOBO:—Sir, the Unofficial Members of this Council would wish to be associated with Your Excellency's tribute to Mr. T. S. Lo.

His distinguished record of public service on this Council and in the Executive Council has won him wide respect.

He will be remembered particularly for his work in the UMELCO Police Group which he joined in 1978 and became Chairman in 1980. Mr. Lo was also Chairman of the Transport Advisory Committee between 1980 and 1982 and served as Convener of the Legislative Council General Services Working Group between 1982 and 1984 and on the Legislation Scrutiny Group between 1978 and 1980.

Sir, we wish Mr. Lo every success in the future.

**Government Business**

**First reading of bill**

**APPROPRIATION BILL 1985**

*Bill read the first time and ordered to be set down for second reading pursuant to Standing Order 41(3).*

**Second reading of bill**

**APPROPRIATION BILL 1985**

THE FINANCIAL SECRETARY moved the second reading of:—'A bill to apply a sum not exceeding $38,361,602,000 to the service of the financial year ending on 31 March 1986'.

TABLE OF CONTENTS OF SPEECH *Paragraphs*

should be easy to operate administratively without additional staffing resources. It will also be recalled that between 1960 and 1982 all adult passengers returning from Macau were limited to a duty free concession of only 100 cigarettes and a litre of wine. The measure proposed will not be popular but in due course we will, no doubt, all become accustomed to it. Accordingly with effect from 1 April the Commissioner of Customs and Excise proposes that the duty free concession for local residents returning to Hong Kong will be limited to 100 cigarettes and one litre of wine. The concession given to overseas visitors will remain as 200 cigarettes and one litre of wine or spirits[(66)].

*Anti-avoidance Legislation*

130. In my winding up speech last year[(67)] I referred to my determination to combat tax avoidance and I gave notice that the anti-avoidance provisions contained in the Ordinance were under study with a view to making them more effective and relevant to our needs. Nothing that has since transpired has persuaded me that we should not now proceed with more effective legislation. Avoidance of our still low taxes is a major preoccupation with an increasing number of taxpayers. It is also clear that the existing legislation does not provide the Revenue with a totally effective defence against those determined to avoid. This simply means increasing the tax burdens on others. I therefore give notice of my intention to introduce appropriate remedial measures. An amendment Bill is now being drafted. Subject to the approval of Executive Council, I anticipate that it will be tabled in this Council before the conclusion of the 1984-85 Session. Specifically, the objectives of the Bill will be—

*firstly* to replace the existing general anti-avoidance provisions contained in section 61 of the Ordinance with legislation which will provide the Commissioner with more effective anti-avoidance powers;

*secondly* to limit the opportunities for tax deferral through leveraged leasing arrangements for equipment used offshore and so-called ‘sale and lease- back’ devices in general, and

*thirdly* to narrow the scope for manipulation of our profits tax expense deductions provisions following a 1983 Privy Council decision.

131. The opportunity will also be taken to introduce some relatively minor technical changes to the principal Ordinance.

---

*(66) The details will be—*

*Visitors*

| | |
|---|---|
| *Liquor* | *—one litre of wine or spirits* |
| *Tobacco* | *—200 cigarettes or 50 cigars or 250 grams of tobacco* |
| *Perfume* | *—60 millilitres* |
| *Toilet water* | *—250 millilitres* |

*Residents*

| | |
|---|---|
| *Liquor* | *—one litre of still wine* |
| *Tobacco* | *—100 cigarettes, 25 cigars or 125 grams of tobacco* |
| *Perfume* | *—60 millilitres* |
| *Toilet water* | *—250 millilitres* |

*(67) Paragraphs 21-25.*

Appendix 2

Hong Kong Institute of
Certified Public Accountants
香港會計師公會

TaxB 16 July 2006

# Tax Bulletin

## 2006

### Annual Meeting

**The Inland Revenue Department**

*and*

**The Hong Kong Institute of Certified Public Accountants**

## Agenda Item A4 – Cross-border Tax Issues

***A4(a) Applicability of Section 39E on contract processing and import processing arrangements***

The Institute would like to follow-up on the responses from the IRD on issues raised at the 2004 Annual Meeting regarding the applicability of section 39E, IRO on contract processing arrangements (Agenda Item A(2)(e) refers).

(i) The Institute would like to clarify the legislative intent of section 39E(1)(b)(i) of the IRO. If the intention was to deny capital allowances in a situation where the plant or machinery was leased for use by the lessee outside Hong Kong because the relevant lease rentals were offshore sourced and non-taxable, the Institute considered that section 18F would be sufficient to serve this purpose.

Mr Chiu replied that section 39E was enacted to limit the opportunities for tax deferral or avoidance through sale and leaseback, offshore equipment leasing and leveraged leasing arrangements. Further, the "used wholly or principally outside Hong Kong" condition in section 39E(1)(b)(i) aimed to encourage the generation of economic benefits in Hong Kong by the use of the machinery or plant in Hong Kong. This was explained in paragraph 16 of DIPN 15 (Revised). Section 39E was introduced in the year 1986 to limit the exploitation of the provisions of the IRO, which conferred tax benefits on a person who had not incurred capital expenditure on the provision of plant or machinery, and which might occur in the case of certain sale and lease back arrangements or other leasing arrangements limiting the liability of the lessor in respect of the debt created in relation to the leasing arrangements. It was not for the intention stated by the Institute. Section 18F was introduced at a much earlier time. If section 18F was sufficient to counteract against the avoidance schemes before section 39E was introduced, the government would not have resorted to its introduction.

As stated in the Hansard, the Financial Secretary, when he moved the second reading of the Inland Revenue (Amendment) Bill 1986, said it was "to limit the opportunities for tax deferral through use of certain machinery or plant under leasing arrangements by denying to a lessor initial and annual allowances where machinery or plant was acquired by him under a sale and leaseback arrangement, or, being other than a ship or an aircraft, was acquired by him through a 'leveraged lease' transaction and is used wholly or principally outside Hong Kong".

(ii) While the IRD would allow 50% of capital allowances for contract processing arrangements (under which only 50% of the Hong Kong entities' profits were taxable), the Institute would like the IRD to consider also granting such a concessionary treatment (i.e. not strictly applying section 39E) to import processing cases where the relevant Hong Kong entities' profits were wholly subject to profits tax. In particular, as the IRD might appreciate, the transfer price for the goods sold by the mainland manufacturers to the Hong Kong entities would usually take into account the provision of plant and machinery by the Hong Kong entities (i.e. the transfer price would have been higher had the Hong Kong entities not provided such plant and machinery to the mainland entities). It should be noted that, given that the manufacturing of goods usually involved specialised technologies, and the generally limited working capital of the mainland entities, manufacturing plant and machinery were required to be provided by the Hong Kong entities under both contract processing and import processing arrangements.

Mr Chiu advised that the arrangement of allowing the Mainland entity to use the plant and machinery in a contract processing case fell within the provision of section 39E. As the plant and machinery were used by that entity outside Hong Kong, no depreciation allowances could be given. However, as 50:50 apportionment of assessable profits was allowed in such a case, the provision of section 39E had not been strictly applied, and, as a concession, 50% of capital allowances were similarly allowed.

There were fundamental differences in the terms of a contract processing agreement and an import processing agreement. Taxpayers involved in import processing arrangements were regarded as traders, who were not owners of the plant and machinery. There was simply no legal basis for the IRD to extend the above-mentioned concession to these taxpayers.

Mr Chiu further pointed out that Assessors found out in some field audit cases that the plant and machinery, allegedly leased to an Foreign Investment Enterprise (FIE) in the Mainland and recorded as fixed assets in the balance sheet of the Hong Kong company, were in fact owned by the FIE on the Mainland. They were either injected as equity into the FIE or purchased by the FIE. In the customs declarations, the plant and machinery were declared as plant and machinery of the FIE. Exemption from customs duties and income tax relief were obtained by the FIE on the Mainland. No evidence was provided to show that the Hong Kong company had paid any withholding tax to the Mainland in respect of any consideration arising from the leasing of the plant and machinery on the Mainland.

(iii) On a related issue, given the definition of "lease" under section 2 of the IRO, it appeared that the plant and machinery provided to the PRC entities under contract processing and import processing arrangements should constitute a "lease" (despite the fact that the assets were provided without charging lease rentals). The Institute would like to seek the IRD's clarification as to whether such plant and machinery would be considered as "excluded fixed assets" under section 16G, IRO. If the answer was in the affirmative and section 39E applied only to import processing cases, this would mean that all Hong Kong entities having import processing arrangements would not be entitled to any deductions/capital allowances for the capital expenditure incurred on the plant and machinery.

Mr Chiu explained that the arrangement for a contract processing case was regarded as a "lease" and the plant and machinery were "excluded fixed assets" for section 16G purposes. However, as the taxpayer involved in an import processing arrangement had no entitlement to the plant and machinery, the question of lease did not arise. An import processing case had been considered by the Board of Review. In *D56/04*, 19 IRBRD 456, the Board, at p.483, agreed with the IRD's view that such plant and machinery represented the taxpayer's capital contribution to the Mainland entity and that depreciation allowance was not due.

Ms Macpherson said it was understood that section 39E were anti-avoidance provisions for defeating opportunities for tax deferral. However, she pointed out that in some import processing cases, the legal title of the plant and machinery still remained in the

Hong Kong entity. Further, the plant and machinery should be considered as being used by the Hong Kong entity in producing products for export.

CIR pointed out that, in import processing cases, the Hong Kong entity was a trader not taking part in any manufacturing processes. Rather, the products were manufactured by a separate entity on the other side of the border, i.e. on the Mainland. Evidence showed that the legal title of the plant and machinery was generally no longer held by the Hong Kong entity. The issue was to be resolved by considering two factors – whether the plant and machinery were owned by the Hong Kong entity and whether they were used in the production of its profits chargeable to tax under the IRO (if not otherwise excluded under section 39E(1)(b)(i)). Ms Macpherson pointed out that import processors incurred substantial costs on plant and machinery and the Mainland enterprise was in effect the manufacturer's agent producing goods for the Hong Kong entity. CIR said if, in a particular case, the two factors applied, then the matter could be considered further.

Appendix 3

Hong Kong Institute of
Certified Public Accountants
香港會計師公會

TaxB 17 September 2007

# Tax Bulletin

2007

## Annual Meeting

**The Inland Revenue Department**

*and*

**The Hong Kong Institute of Certified Public Accountants**

**A3(b) Plant and machinery used in import processing**

In the minutes of the 2006 Annual Meeting (Agenda Item A4(a)), the CIR said, in situations where the plant and machinery were owned by the Hong Kong entity and they were used in the production of chargeable profits, the matter could be considered further:

> " CIR pointed out that, in import processing cases, the Hong Kong entity was a trader not taking part in any manufacturing processes. Rather, the products were manufactured by a separate entity on the other side of the border, i.e. on the Mainland. Evidence showed that the legal title of the plant and machinery was generally no longer held by the Hong Kong entity. The issue was to be resolved by considering two factors – whether the plant and machinery were

owned by the Hong Kong entity and whether they were used in the production of its profits chargeable to tax under the IRO (if not otherwise excluded under section 39E(1)(b)(i)). Ms Macpherson pointed out that import processors incurred substantial costs on plant and machinery and the Mainland enterprise was in effect the manufacturer's agent producing goods for the Hong Kong entity. *CIR said if, in a particular case, the two factors applied, then the matter could be considered further*." (emphasis added.)

The Institute would like the IRD to clarify, how the matter was treated, in practice, if the two factors were satisfied.

It was not uncommon for a Hong Kong company to be responsible for moulds that were loaned to the Mainland supplier or manufacturer. Such moulds were usually used solely for the production of products that belonged to the Hong Kong company. If there was no depreciation allowance allowed, this appeared to be in violation of the basic principle of allowing taxpayers to get relief for costs incurred in generating revenue. Alternatively, one can argue there was an imputed rental income for the use of the moulds outside Hong Kong included in the profits of the Hong Kong entity and such rental income should be excluded from the assessable profits of the Hong Kong entity since the moulds were used outside Hong Kong.

The Institute would like the IRD to advise its position on this issue.

Mrs Chu pointed out that, for import processing cases, information available to the IRD indicated that in most cases the Hong Kong entities were not legal owners of the P&M involved. Rather, the FIE on the Mainland generally attained legal ownership of the P&M through injection of the P&M as equity by the Hong Kong entity into the FIE or purchasing of the P&M by the FIE itself. Even if the Hong Kong entity continued to own the P&M provided to the FIE, it would be difficult for the IRD to ascertain that the P&M was not subsequently sold or transferred to other parties, that depreciation allowances on the same P&M were not claimed by other entities, and that the P&M was not used to produce goods sold otherwise than to the Hong Kong entity. The IRD would look at the actual arrangement and not merely rely on audited accounts as sufficient proof of ownership of the P&M imported into the Mainland.

Ms Law asked whether there were circumstances in which the Hong Kong company did not own the factory on the Mainland that could be acceptable as apportionment cases? She added that the situation in the Mainland had changed, as previously, in order to obtain a subcontracting contract, it was necessary for the Hong Kong company to own a factory. This was no longer the case. Mr Chiu replied that the IRD looked at the actual operations and considered whether the Hong Kong company was really carrying out operations in the Mainland. A right of domestic sales, for example, meant that the P&M was not exclusively being used in relation to Hong Kong.

The IRD, however, would explore the matter further and welcomed the Institute's input on possible safeguards against abuses should the concession be extended. For obvious reasons, the IRD would review the current practice of granting concession to contract processing cases in like circumstances and consider if the same set of restrictive criteria should be applied.

**Appendix 4**

Inland Revenue Department
Hong Kong

# DEPARTMENTAL INTERPRETATION AND PRACTICE NOTES

## NO. 15(REVISED)

| | | |
|---|---|---|
| **(A)** | **LIMITATION OF LOSS RELIEF** | **(SECTION 22B)** |
| **(B)** | **LEASING ARRANGEMENTS** | **(SECTION 39E)** |
| **(C)** | **GENERAL ANTI-AVOIDANCE PROVISION** | **(SECTION 61)** |
| **(D)** | **GENERAL ANTI-AVOIDANCE PROVISION** | **(SECTION 61A)** |
| **(E)** | **LOSS COMPANIES** | **(SECTION 61B)** |
| **(F)** | **RAMSAY PRINCIPLE** | |
| **(G)** | **PENALTY ON TAX AVOIDANCE CASES** | |
| **(H)** | **GUIDELINES ON LEASE FINANCING** | |
| **(I)** | **ADVANCE RULINGS** | |

These notes are issued for the information of taxpayers and their tax representatives. They contain the Department's interpretation and practices in relation to the law as it stood at the date of publication. Taxpayers are reminded that their right of objection against the assessment and their right of appeal to the Commissioner, the Board of Review or the Court are not affected by the application of these notes.

These notes replace those issued on 1 May 1986, on 15 November 1990 and in September 1992.

LAU MAK Yee-ming, Alice
Commissioner of Inland Revenue

January 2006

4. A limited partner cannot claim a loss set-off in excess of the "relevant sum", which is the amount of his contribution to the partnership as at the end of the relevant year of assessment in which the loss is sustained. If the person ceased to be a partner in the partnership during that year of assessment the appropriate time is the time when he so ceased.

5. The loss set-off of a limited partner is restricted to the lesser of:

(a) his share of the partnership loss; or

(b) the relevant sum.

6. Any loss not set off is carried forward in the partnership and set off against future assessable profits of the partnership. They are not available for set-off against other assessable profits which the limited partner may have in subsequent years.

7. In applying the provisions it is necessary to ascertain the amount of the limited partner's contribution to the partnership. This is the aggregate of the amounts of capital contributed to the partnership and not withdrawn, whether directly or indirectly, or otherwise received back, and any profits or gains which have not been withdrawn from the partnership, whether in money or money's worth. Anything which the limited partner is, or may be, entitled to draw out, receive back, or be reimbursed from another person at any time whilst the partnership carries on the trade, profession or business must be deducted.

## PART B - LEASING ARRANGEMENTS (SECTION 39E)

### *The position in general*

8. Section 39E was enacted to limit the opportunities for tax deferral or avoidance through sale and leaseback, offshore equipment leasing and leveraged leasing arrangements. In broad terms section 39E operates to deny to a lessor (owner) initial and annual allowances ("depreciation allowances") in respect of any machinery or plant owned by him where a person holds rights as lessee under a lease of the machinery or plant and:

(a) the machinery or plant was previously owned and used by the lessee or his associate (i.e. a sale and leaseback arrangement), or

(b) the machinery or plant, other than a ship or aircraft or any part thereof, is while the lease is in force:

(i) used wholly or principally outside Hong Kong by a person other than the lessor; or

(ii) the whole or a predominant part of its cost of acquisition or construction was financed directly or indirectly by a non-recourse debt (i.e. a leveraged lease arrangement); or

(c) the machinery or plant is a ship or aircraft or any part thereof and:

(i) the lessee is not an operator of a Hong Kong ship or aircraft; or

(ii) the whole or a predominant part of its cost of acquisition or construction or the part thereof was financed directly or indirectly by a non-recourse debt.

***The lease***

9. Under section 2 of the Ordinance, lease in relation to any machinery or plant includes:

(a) any arrangement under which a right to use it is granted by the owner to another person; and

(b) any arrangement under which a right to use it, being a right derived directly or indirectly from a right referred to in paragraph (a), is granted by a person to another person, but does not include a hire-purchase agreement or a conditional sale agreement unless the Commissioner considers that the right under the agreement to purchase or obtain the property in the goods would reasonably be expected not to be exercised.

***Party identification***

10. In general the reference to "taxpayer" in section 39E connotes the lessor (owner) who has incurred capital expenditure on the provision of the machinery or plant being leased. The party which ultimately uses the machinery or plant is described as the "end-user", who is either:

(a) the lessee, either alone or with others, or

(b) an "associate" of the lessee.

For this purpose the term "associate" has been defined widely in section 39E(5) in order to prevent circumvention of the provision by the interposition of third parties.

***Sale and leaseback***

11. Denial of depreciation allowances in section 39E(1)(a) is intended to prevent an overall tax benefit being obtained through the sale and leaseback of machinery or plant.

12. Section 39E(1)(a) refers to leased machinery or plant which at any time prior to its acquisition by the lessor was owned and used by the end-user. "Owned" is not defined but is a word of common usage and in practice will be given its ordinary meaning. "Used" is defined to include "held for use" meaning installed ready for use or held in reserve. The term "ready" denotes a condition of functional operability.

13. Section 39E(2) provides an exception to the general rule that no initial or annual allowances will be granted in respect of machinery or plant acquired under a sale and leaseback arrangement. This exception applies in the situation where:

(a) a lessor purchases machinery or plant from an end-user at a price not greater than the price paid to the supplier (being a supplier who is not an end-user) by the end-user; and

(b) no initial or annual allowances have been made to the end-user in respect of that machinery or plant prior to its acquisition by the lessor.

**Example 1**

*Company L is a leasing company whereas Company A is a manufacturing company. Both companies are carrying on business in Hong Kong. Under a sale and leaseback arrangement, Company A after revaluing its old machinery and plant sold them to Company L. Company L in turn leased the machinery and plant back to Company A for rental. Before the arrangement, depreciation allowances on the machinery and plant were made to Company A.*

Company L would be denied depreciation allowances in respect of the machinery and plant under section 39E(1)(a) because they were owned and used by Company A prior to acquisition. The exception in section 39E(2) did not apply because depreciation allowances were previously granted to Company A.

**Example 2**

*Company B purchased machinery of $100 million. Before putting them into use and claiming any depreciation allowances, Company B sold to and leased back from Company L the machinery. Under the sale and leaseback arrangement, Company B obtained cash proceeds of $100 million which was the price he paid the supplier and was required to pay a rental of $11 million for a consecutive period of ten years. Assuming each instalment contained an effective finance charge of $1 million whereas the market interest should have been $2 million, Company B in effect transferred the depreciation allowances to Company L in return for a lower rate of interest. Company B after receiving the cash of $100 million applied the money for other commercial transactions to produce chargeable profits.*

The conditions in section 39E(2) are satisfied. Company L would not be denied depreciation allowances. Company B in effect made use of the sale and leaseback arrangement to obtain cheaper finance for its business use. Company L, the lessor, had in effect committed capital into the machinery, incurring genuine commercial risk. The whole arrangement is a normal commercial transaction.

14. Because entitlement to these allowances is mandatory upon acquisition of machinery or plant, in order for the exception in paragraph 13 to apply it will be necessary for the end-user to submit a disclaimer to the Commissioner in writing within 3 months of the date on which the machinery or plant was acquired, or within such further period as the Commissioner may permit. Generally, the Department will not entertain requests for an extension of the 3 months disclaimer period. A notice of disclaimer should be accompanied by the following information:

(a) a description of the relevant asset;

(b) the name and address of the supplier;

(c) the date of purchase from and price paid to the supplier;

(d) the date of sale to and price paid by the lessor; and

(e) the name and address of the lessor.

The above information must be supported by copies of purchase and sale agreements or invoices and the lease agreement.

15. After submitting notice of a disclaimer, the end-user might decide to retain the right to claim depreciation allowances and seek to cancel the sale and leaseback arrangement. As a concession, the Department is prepared to allow the withdrawal of a disclaimer, provided that the relevant assessment has not yet become final and conclusive.

***Used wholly or principally outside Hong Kong***

16. The "used wholly or principally outside Hong Kong" condition in section 39E(1)(b)(i) aims to encourage the generation of economic benefits in Hong Kong by the use of the machinery or plant in Hong Kong.

17. The question whether a particular item of machinery or plant is used "wholly or principally" outside Hong Kong is a question of fact to be decided having regard to the circumstances of the case. The following matters are, however, likely to be relevant in determining the issue:

(a) the place where the asset is physically located and put to use or held for use;

(b) the nature of the asset;

(c) the nature of the end-user's business;

(d) the locality in which the asset is, under the terms of the lease, designated for use throughout the period of the lease.

**Example 3**

*Company L is a leasing company carrying on business in Hong Kong. Company C is an enterprise carrying on business in Mainland China. Company L leased its machinery to Company C for rental.*

Company L would be denied depreciation allowances in respect of the machinery under section 39E(1)(b)(i) because the machinery was used wholly outside Hong Kong. It should be noted that no deduction would be given under section 16G because the machinery under a lease is an "excluded fixed asset" as defined in section 16G(6). As a practice, the rental income accrued to Company L from leasing the machinery would be regarded as non-taxable.

18. No doubt cases will arise where leased machinery or plant will be used, either in one year, or, over a period of years, both within and outside Hong Kong. In these cases the Department will look at each leased asset and each year of assessment separately. If in a particular year the machinery or plant is used wholly or principally in Hong Kong then the prescribed depreciation allowances will be granted. On the other hand, if in a particular year the machinery or plant is not used wholly or principally in Hong Kong then no allowances will be granted. For the purposes of determining the written down value of the item to be carried forward, the notional amount of allowances which would have been granted had the item been used in Hong

Kong will be deducted from the written down value brought forward. Any balancing adjustments on the sale of the item will be calculated on a pro-rata basis.

19. Under a contract processing arrangement with a Mainland Chinese enterprise, a Hong Kong company is often required to provide machinery or plant for the use of the Mainland Chinese enterprise. Such arrangement is a lease as defined in section 2 (see paragraph 9) and therefore section 39E needs to be considered. Even though the machinery or plant is not used wholly or principally in Hong Kong, the Department as a concession is prepared to allow 50 per cent of the depreciation allowances on the leased machinery or plant on the condition that the profits from manufacturing activities of the Hong Kong company are assessed on a 50:50 basis. The concession however will not apply where the Hong Kong company has ceased to be owner of the machinery or plant. For example, the Hong Kong company will be denied depreciation allowances on the machinery or plant which are injected as its share of equity of a "foreign investment enterprise" ("FIE") in the Mainland, as such machinery or plant is owned by the FIE.

**Example 4**

*Company D is carrying on a manufacturing business in Hong Kong. Under a contract processing arrangement with a Mainland Chinese enterprise, Company D is required to provide machinery and plant to the Mainland Chinese enterprise for the latter's processing work. Company D did not charge the Mainland Chinese enterprise any rental for the use of the machinery and plant.*

Although no rental is charged, the arrangement is still a lease as defined in section 2. As the machinery or plant is under a lease, it is an "excluded fixed asset" under section 16G(6) and falls outside the purview of section 16G. Hence, no deduction under that section would be given. Strictly, Company D should be denied depreciation allowances in respect of the machinery and plant leased to the Mainland Chinese enterprise under section 39E(1)(b)(i). However, if the profits from the manufacturing activities of Company D are assessed on a 50:50 basis, the Department would be prepared to grant 50 per cent of the depreciation allowances as a concession.

**Example 5**

*Company G is carrying on business in Hong Kong and is the holding company of Company H. Company H is a wholly owned foreign enterprise set up as a separate legal person in the Mainland. Company G purchased machinery and plant and injected them into Company H as its capital contribution in specie.*

As a result of the capital contribution, Company G has ceased to be owner of the machinery and plant. In effect, Company G has sold the machinery and plant in return for its equity interest in Company H. The question of a lease does not arise. Thus Company G would not be entitled to any depreciation allowances.

***Ships or aircraft***

20. Where the asset is a leased ship or aircraft the law prescribes a different test for deciding whether initial or annual allowances shall be granted to the taxpayer (lessor) – see section 39E(1)(c). In such cases the question is not whether the ship or aircraft is used wholly or principally outside Hong Kong but whether the person holding rights as lessee (the end-user) is an operator of a Hong Kong ship or aircraft. An operator of a Hong Kong ship or aircraft is a person who carries on business as an operator of ships or aircraft being a business controlled and managed in Hong Kong and:

(a) in the case of an aircraft, holds an air operator's certificate issued under the Air Navigation (Hong Kong) Order 1995 (Cap. 448 sub. leg. C); or

(b) in the case of a ship, is responsible for meeting all, or a substantial portion of the operating expenses of the ship and the ship operates mainly in the waters of Hong Kong or between the waters of Hong Kong and waters within the river trade limits.

***Leveraged leases***

21. A leveraged lease arrangement, as it has become known to this Department, is typically one in which a partnership of companies acquires machinery or plant (generally ships or aircraft) which it leases for a term of

years to a lessee and where, by reason of the "leverage" obtained from the borrowing of a substantial non-recourse loan, the members of the partnership are effectively at risk for no more than a relatively small part of the funds used to acquire the asset. The lenders' security for the substantial amounts lent to acquire the asset is limited to the asset itself and/or by way of a charge over the lease and the related lease payments.

22. So far as it relates to leveraged leases, section 39E denies initial and annual allowances to a taxpayer (lessor) where the whole or a predominant part of the cost of machinery or plant was financed directly or indirectly by a non-recourse debt.

23. The term "non-recourse debt" is defined extensively in section 39E(5) but in broad terms means, as mentioned above, a method of financing where the borrower has no absolute liability in respect of the borrowing and in the event of default in repayment the rights of the lender are restricted to the asset itself or the income generated by it. For the purposes of this provision the Department will generally accept that where a taxpayer (lessor) actually contributes or is fully at risk for at least **51** per cent of the cost of the asset then the financing is not predominantly by a non-recourse debt and in such cases section 39E(1) will have no application.

## PART C - GENERAL ANTI-AVOIDANCE PROVSION (SECTION 61)

### *The position in general*

24. Section 61 empowers the Assessor to disregard certain transactions or dispositions and assess the taxpayer accordingly. This section is not a charging section, but serves to protect the liability for tax established under other sections of the Ordinance. This proposition is consistent with the dicta of Richardson J in *Challenge Corporation Limited [1986] 8 NZTC 5,001 [CA]* on the status of New Zealand's general anti-avoidance provision *(at page 5,019)*:

> "Section [the relevant general anti-avoidance provision] is not an independent charging provision. It does not itself create a liability for income tax; its function is to protect the liability for income tax established under other provisions of the legislation."

Hong Kong Institute of
Certified Public Accountants
香港會計師公會

TaxB 19 October 2009

# Tax Bulletin

2009

## Annual Meeting

**The Inland Revenue Department**

*and*

**The Hong Kong Institute of Certified Public Accountants**

**<u>Agenda Item A3 - Cross-border Tax Issues</u>**

**(a) Depreciation on plant and machinery used in import processing trade**

While this subject had been raised at the previous three annual meetings with IRD (Agenda Item A4(a) in 2006, Item A3(b) in 2007 and Item A3(b) in 2008 annual meetings) the concerns remained as it affected many taxpayers involved in manufacturing operations in the Mainland. This was particularly important during the current difficult times faced by manufacturing businesses.

IRD had raised a number of concerns, such as whether the plant & machinery (P&M) had been sold or transferred to other parties, whether depreciation allowances on the same P&M had been claimed by third parties, whether the P&M had been used to manufacture goods sold other than to the taxpayer, etc.

(i) The Institute would like to know, in principle, whether IRD considered that depreciation allowances could, in any circumstances, be granted to a Hong Kong taxpayer who owned P&M under a non-contract processing arrangement, where the P&M were used in the Mainland by a Mainland entity to produce goods sold to the Hong Kong taxpayer whose profits were 100% taxable in Hong Kong (and whether 50% of the depreciation allowances on the P&M would be granted if the profits of the Hong Kong taxpayer were 50% taxable in Hong Kong).

    If IRD considered that this was not possible because of the operation of section 39E of the IRO, the Institute would like to know how to reconcile the difference in practice for allowing 50% depreciation allowances by concession in contract processing cases while disallowing depreciation allowances in import processing cases.

    If IRD considered that their present position should be maintained, the Institute would like to know whether, in view of the current difficulties faced by manufacturers, IRD would consider allowing depreciation allowances by concession to taxpayers operating import processing arrangements (if not permanently, at least for a finite period) so that they would be on a level playing field with those operating contract processing arrangements.

CIR explained that, as indicated in the 2008 Annual Meeting [Agenda Item A3(b)], IRD considered that the provisions in section 39E(1)(b)(i) were clear and unambiguous and that no depreciation allowances should be given to the owner if the plant and machinery were used wholly or principally outside Hong Kong by a person other than the taxpayer.

In a contract processing arrangement, the Hong Kong entity had carried out activities in the Mainland and Hong Kong. According to the provisions of the DTA with the Mainland, the Hong Kong entity with a contract processing arrangement could be regarded as having a permanent establishment in the Mainland and was liable to tax there. Reference could be made to paragraph 7 of DIPN 44. IRD was of the view that Hong Kong entities which manufactured goods through a contract processing arrangement had operations in the Mainland whereby they were regarded as using the plant and machinery there. In these situations, section 39E(1)(b)(i) was not applicable and they were allowed depreciation allowances as a concession. For entities engaging in import processing arrangement, it was the foreign investment enterprises in the Mainland which used the plant and machinery. Hence, section 39E(1)(b)(i) applied to deny depreciation allowances.

(ii) The Institute would like to know if the position would be different if the Mainland sub-contractor were an unrelated third party, in which case the concern about the relevant P&M being contributed as an equity investment by the Hong Kong taxpayer to the Mainland subcontractor should generally be allayed?

CIR advised that a taxpayer who had contributed plant and machinery as equity investment was clearly not entitled to depreciation allowances because he no longer owned the plant and machinery. Section 39E was not engaged.

CIR explained that the operation of section 39E(1)(b)(i) did not hinge on whether the person who used the plant and machinery overseas was a related party or not.

(iii) The Institute would like to know how many cases of disputes involving rejection of claims for depreciation allowances under section 39E (1)(b)(i) for import processing arrangements were being handled by IRD and whether IRD anticipated that any of these disputes would be brought before the Board of Review or the Court.

CIR said that IRD did not have statistics on the number of claims rejected. Any taxpayer who was engaged in import processing arrangement and does not agree with the denial of depreciation allowances under section 39E(1)(b)(i) of the IRO could pursue his claim through the objection and appeal channel. Recently a case involving this issue was heard by the Board of Review and a decision was pending.

(iv) The Institute would like to know if IRD agreed that the original intention of enacting section 39E was not to target taxpayers involved in manufacturing operations in the Mainland.

CIR advised that section 39E was enacted to limit the opportunities for tax deferral or avoidance through sale and leaseback, offshore equipment leasing and leveraged leasing arrangement. As explained in paragraph 16 of DIPN 15 (Revised), the condition of "used wholly or principally outside Hong Kong" in section 39E(1)(b)(i) aimed to encourage the generation of economic benefits in Hong Kong by the use of machinery or plant in Hong Kong. The meaning of the condition was plain and clear.

Mr Mak recalled that when the provision was first introduced, it had been observed that there were few cases of plant and machinery being used by Hong Kong manufacturers in the Mainland. CIR said that, even were this so, in the case of import processing, ownership of the plant and machinery changed hands. For contract processing cases, the concession would continue to apply, but it would not be further expanded.

LC Paper No. CB(2) 1469/10-11(01)

ACCA

**Appendix 6**

Hon Paul CHAN Mo-po, MH, JP
Legislative Councillor (Accountancy)
Room 410 West Wing
Central Government Offices
Hong Kong

29 March 2011

Dear Sir

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

The Bill was gazetted on 25 February 2011. The initiative was proposed by the Financial Secretary in his 2010 Budget Speech and its purpose is "to promote the wider application of intellectual property by enterprises and the development of creative industries". As it is currently drafted, the Bill will not be able to serve such purpose and will cause concern that is similar to the current problem caused by section 39E of the Inland Revenue Ordinance. On behalf of ACCA (Association of Chartered Certified Accountants) Hong Kong, we would like to raise our concerns as follows and suggest that the Bill should be further examined by a Bills Committee before it is enacted.

***Licensing specified Intellectual Property use outside Hong Kong***

While section 16EA provides deduction of capital expenditure on specified intellectual properties (that are copyright, registered design and registered trade mark), section 16EC, as an anti-avoidance measure imposes restrictions on the deduction similar to existing section 39E on leased plant and machinery.

In the situation where the owner (licensor) of the specified intellectual property (IP) licenses the IP to companies (associated or non-associated) for them to use outside Hong Kong, under the current practice of the Inland Revenue Department (IRD) as explained in paragraph 45 of the Departmental Interpretation and Practice Note 21 (DIPN21), the source of the royalties received by the licensor will be in Hong Kong and subject to profits tax if the place of acquisition and granting of the licence is Hong Kong. However the cost of the IP will not be deductible under the proposed section 16EC(4)(b) of the Bill.

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ACCA

The asymmetry in treatments of the royalties derived from the IP and the deduction of the cost of IP may not serve the original intention of the Bill.

***Use of the IP outside Hong Kong under sub-contracting***

The proposed section 16EC(4)(b) may also cause problem to owner of the IP to produce goods using the IP through sub-contractors outside Hong Kong. Section 16EA allows deduction of the cost of IP irrespective whether the IP is *used* in Hong Kong or outside Hong Kong. "Use" means use by the owner in its own production. If the production is carried out by a sub-contractor outside Hong Kong, strictly speaking, the IRD may disallow the deduction of the cost of the IP on the ground it is not used by the owner but by someone else (sub-contractor) under license outside Hong Kong. As such, deduction on the cost of the IP will be denied under section 16EC(4)(b). The situation will be similar to the denial of depreciation allowances on plant and machinery under the existing section 39E.

***Use of the IP by another person other than the taxpayer who incurs the expenditure***

S16EA(2) allows the deduction if "Any specified capital expenditure *incurred by the person*......if the specified intellectual property right concerned is purchased *for use in the trade, profession or business* in the production of profits in respect of which the person is chargeable to tax". In the case where the IP is licensed to another person for use in HK, clarification is required whether deduction will be denied by the IRD on the ground that the IP is not for use in the business of the taxpayer but by someone else (the licensee). This will be a very narrow interpretation and is completely contrary to the intention of the Bill.

The above situations warrant further examination before the Bill is enacted. We suggest a Bills Committee be formed and comments from the business and profession be invited. Should you wish to discuss the above suggestions in more detail, kindly please feel free to contact us at 2524 4988.

Yours faithfully

Rosanna Choi
*Chairman*

財經事務及庫務局

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**Appendix 7**

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本函檔號 Our Ref. :
來函檔號 Your Ref.: CB1/B/FST/2/10

6 April 2011

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

Dear Miss LEUNG,

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

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

**Background**

2. The Administration introduced the Bill into the Legislative Council on 9 March 2011 with a view to giving effect to the proposal announced in the 2010-11 Budget to provide tax deduction for capital expenditure incurred on the purchase of copyrights, registered designs and registered trade marks ("specified IPRs"). The objectives are to promote the wider application of intellectual property rights ("IPRs") by enterprises, to encourage innovation and upgrading and to facilitate development of creative industries in Hong Kong.

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

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

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

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

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

*(a) Licensing specified IPRs for use outside Hong Kong*

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

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

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

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

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

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

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

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

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

Yours sincerely,

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

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

**Appendix 8**

# *立法會*
# *Legislative Council*

LC Paper No. CB(1)489/11-12

Ref: CB1/BC/4/10

**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 -

(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;

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

(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.

<u>Copyrights, registered designs and registered trade marks</u>

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.

<u>Patent rights and rights to any know-how</u>

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.

<u>Anti-avoidance Provisions</u>

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").

<u>Conditions for the proposed tax deduction</u>

*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

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.

<u>Power of Commissioner to determine true market value of IPRs</u>

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.

<u>Anti-avoidance provisions</u>

*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

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

[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.

<u>Departmental Interpretation and Practice Notes</u>

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 CSAs to be moved by the Administration. The Bills Committee has not proposed any CSA 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.

**Consultation with the House Committee**

70. The House Committee was consulted on 25 November 2011 and supported the recommendation of the Bills Committee in paragraph 69.

Council Business Division 1
Legislative Council Secretariat
2 December 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*

**Appendix III**

**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 November 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.*

<u>*Scenario 1*</u>
*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.

<u>*Scenario 2*</u>

*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.

<u>*Scenario 3*</u>

*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:

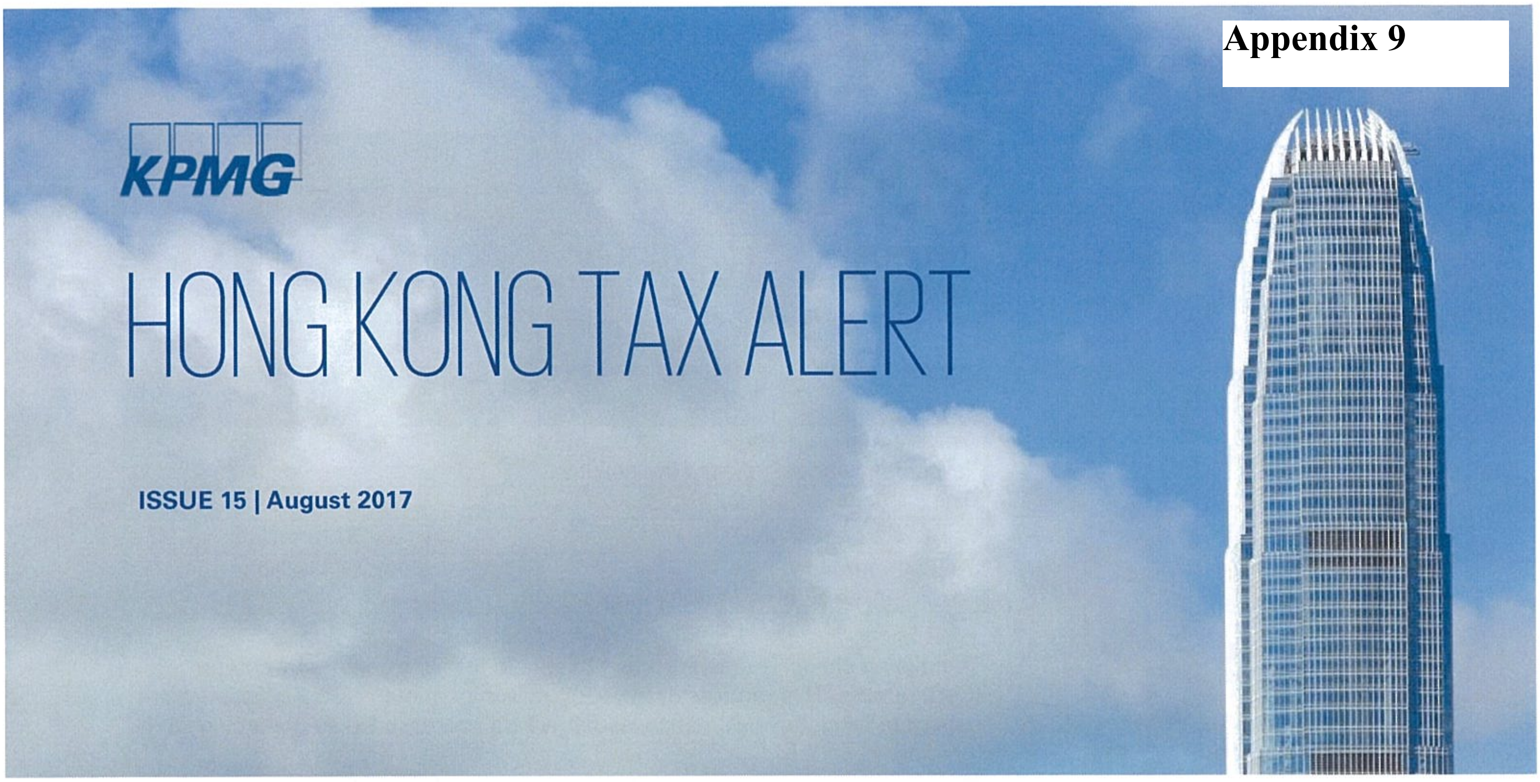
$$\text{Purchase price of the Mainland registered trade mark} \times \frac{\text{No. of units sold in the Mainland}}{\text{No. of units manufactured and sold in the Mainland}} \div 5$$

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

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

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.

**Appendix 9**




# Consultation report on BEPS lays out the foundation for Hong Kong's transfer pricing regime


## Summary

The Hong Kong Government issued a follow-up BEPS Consultation Report addressing public feedback and laying out its intentions on the forthcoming transfer pricing rules.


## Overview

The Hong Kong government this week issued its *Consultation Report on Measures to Counter Base Erosion and Profit Shifting* (click here). The report summarises the feedback received during the public consultation exercise that ended on 31 December 2016. More specifically, it explains how the government intends to implement a new transfer pricing regime in Hong Kong.

According to the report, there is overwhelming support from those who responded to the consultation exercise to codify transfer pricing rules into the law.

The government plans to introduce a Bill for this purpose into LegCo by the end of 2017. The Bill will refer to the OECD's transfer pricing guidelines and clarify which version of these guidelines should be followed. The IRD will subsequently issue a Departmental Interpretation and Practice Note (DIPN) to facilitate the understanding of the "fundamental transfer pricing rule" in the future. This rule essentially empowers the IRD to adjust the profits or losses of an enterprise that engages in non-arm's length dealings with associated enterprises.

The report sets out the following key updated proposals:

- *Exemption thresholds for transfer pricing documentation*. There has been a positive development regarding exemption thresholds for the preparation of master and local files. The thresholds have been relaxed and are now based on (i) the size of the business, and (ii) related party transaction amounts as detailed in the tables below. This relaxation will help to reduce the compliance burden for taxpayers.

  Specifically, taxpayers will not be required to prepare master and local files if they meet either one of the following two sets of exemptions:

| (a) Based on size of business (any two of three criteria) | Threshold (HK$) per financial year |
|---|---|
| Total annual revenue | ≤ $200 million |
| Total assets | ≤ $200 million |
| Employees | ≤ 100 |

| (b) Based on related party transactions (for that particular category of transactions) | Threshold (HK$) per financial year |
|---|---|
| Transfers of properties (excludes financial assets / intangibles) | < $220 million |
| Transactions in financial assets | < $110 million |
| Transfers of intangibles | < $110 million |
| Any other transactions (e.g., service income / royalty income) | < $44 million |

There is no change to the reporting threshold for filing country-by-country (CbC) reports. This remains at EUR 750 million or about HK$6.8 billion. Parent surrogate filing implementation issues will be addressed in an upcoming DIPN.

- *Domestic transactions*. Domestic transactions will be included in the transfer pricing regime. Additional effort will be required to ensure that domestic transactions comply with the arm's length standard.

- *Intellectual property ("IP")*. Because of the practical difficulties in relying on the fundamental transfer pricing rule to address IP issues, specific provisions will be introduced to ensure that a person who develops, enhances, maintains, protects and exploits IP in Hong Kong (so-called DEMPE functions) will be compensated with a return calculated on an arm's length basis.

- *Penalties*. Penalties for incorrect tax returns relating to non-arm's length pricing remain the same as those that apply generally for under-reporting in other tax contexts. These can amount up to 300% of the tax undercharged if there is lack of "reasonable excuse" or there is a "wilful intent to evade tax". Unfortunately, the preparation of OECD-compliant transfer pricing documentation will not automatically lead to a reduction of penalties. Rather, conditions for penalty reduction will be based on the actual facts and circumstances, with transfer pricing documentation being only one of the factors to be considered. There is no specific mention of interest being charged in addition to penalties.

- *Advance pricing arrangements (APAs) / arbitration*. The implementation of statutory transfer pricing rules and the anticipated rise in demand for APAs will give rise to more demands for certainty, and will likely lead to more disputes.

  The Bill will give the IRD more flexibility to cater for unilateral, bilateral and multilateral APAs. A DIPN will provide further details. A DIPN will also provide details of the proposed dispute resolution mechanism. In the meantime, Hong Kong will continue to expand its network of tax treaties to enhance the process for resolving double taxation issues arising from transfer pricing disputes.

- *Other points*.
  - Hong Kong will not impose thin capitalisation rules.
  - Unfortunately, the Bill will not contain any safe harbour rules.
  - The time bar for claiming tax credits will be extended to six years.
  - Taxpayers will be required to take all reasonable steps to minimise the amount of foreign tax payable before claiming a tax credit. (Relevant details will released in a future DIPN.)
  - The government proposes to introduce the new Bill into LegCo by the end of 2017.

## KPMG Observations

The government has reiterated that it will take a pragmatic approach to minimize the compliance burdens on businesses arising from the new transfer pricing regime, particularly for small and medium enterprises.

In particular, the documentation exemption criteria have been relaxed. The exemption criteria for both annual revenue and total assets have been increased to HK$200m from the original HK$100m. This will exempt more taxpayers from the need to prepare master files. So far as the threshold for preparation of local files is concerned, the rules now refer to the size of related party transaction amounts, with the amounts generally mirroring those that apply in Mainland China. Furthermore, if a taxpayer is exempted from preparing a local file, it is also not required to prepare a master file. This is also in line with Mainland China's exemption provisions.

Parent surrogate filing implementation issues will be addressed in an upcoming DIPN. This requires Hong Kong to sign multilateral competent authority agreement (MCAAs) as a prerequisite. If the MCAA is not signed in time, Hong Kong headquartered multinationals may need to individually file CbC reports in the relevant jurisdictions of their subsidiaries until a MCAA or specific BCAAs takes effect. This will have impact on Hong Kong headquartered groups that plan to do compulsory and parent surrogate filing of CbC reports in Hong Kong, as well as to non-Hong Kong based groups who may elect to do secondary filing here, and further clarifications by the Government would be welcomed.

The Government is being cautious about BEPS compliance because it is eager to comply with the OECD's and EU's expectations in their efforts to counter harmful tax practices. With this in mind, although the government has relaxed some of its initial provisions (e.g., exemption thresholds for transfer pricing documentation), it has maintained its stance on other issues (e.g., domestic transactions are still being targeted).

In anticipation of these coming mandatory transfer pricing documentation requirements, we highly recommend that taxpayers in Hong Kong begin to proactively assess, if they have not already done so, their potential compliance obligations. Also, taxpayers would need to consider carefully the impact of their related-party domestic transactions within Hong Kong as well.

For more information, or if you require assistance, please contact any of our Transfer Pricing contacts:

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