Proposed tax deduction for purchase costs incurred on three new types of intellectual property rights (IPRs)

The Inland Revenue (Amendment) (No. 2) Bill 2018 (the Bill)\(^1\), gazetted on 23 March 2018, proposes to extend the current regime for tax deduction for IPRs to cover three new types of IPRs, namely (i) performer’s economic right; (ii) protected layout-design (topography) right; and (iii) protected plant variety right.

As a result, in most cases, royalties received by a non-resident in respect of their granting the use of, or the right to use, the three additional IPRs to a Hong Kong taxpayer will be deemed to be profits of the non-resident chargeable to tax in Hong Kong under sections 15(1)(b) or (ba) of the Inland Revenue Ordinance (IRO).

In addition, sums received by a non-resident from the sale or assignment of a performer’s economic right will also be deemed to be profits of the non-resident chargeable to tax in Hong Kong under a new deeming section 15(1Xbb) of the IRO, where such right relates to a performance given in Hong Kong on or after the date on which the Bill is enacted into law.

This alert explains the main provisions of the Bill.

In the meantime, clients who have any views or comments on the Bill can contact their tax professionals so that we can convey their thoughts to the Government in an appropriate manner.

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Current tax deduction regime for specified IPRs

Section 16EA - Capital expenditure incurred on the purchase of registered trademarks, copyrights and registered designs is deductible, generally spread over five years, commencing from the year of purchase.

Section 16EB - Where a relevant IPR is subsequently sold, the sale proceeds will be compared with the cost of the IPR that has not yet been allowed for a tax deduction. Where the sales proceeds exceed the unallowed amount of the IPR, the difference, capped at the total amount previously allowed, will be treated as a trading receipt. In the case the unallowed amount exceeds the sale proceeds, the difference will qualify for a tax deduction.

Section 16EC - This anti-avoidance provision will deny a tax deduction where a relevant IPR is (i) purchased from an associate (i.e., section 16EC(2)); (ii) used wholly or principally outside Hong Kong under the term of a license by a person other than the taxpayer (i.e., section 16EC(4)(b)); (iii) used in certain sale-and-lease-back arrangements; (iv) acquired by way of certain non-recourse debt arrangements; or (v) acquired in a manner which involved the early termination of a license in certain circumstances.

Major provisions of the Bill

Expanding the scope of the current regime for tax deduction to cover additional three types of IPRs

The Bill proposes to amend section 16EA of the IRO to expand the definition of specified IPRs to cover three additional types, namely (i) performer’s economic right; (ii) protected layout-design (topography) right; and (iii) protected plant variety right.

As a result, the current provisions contained in sections 16EA, 16EB and 16EC of the IRO governing the tax treatments of the existing specified IPRs will apply equally to the three additional IPRs.

Royalties received by a non-resident from a Hong Kong taxpayer in respect of the three new IPRs will be chargeable to tax in Hong Kong

The Bill amends the terms of section 15(1)(b) and section 15(1)(ba) of the IRO to explicitly deem that, in most cases, royalties received by a non-resident in respect of their granting the use of, or the right to use, the three new IPRs to a Hong Kong taxpayer will be profits of the non-resident chargeable to tax in Hong Kong.

Sums received by a non-resident from the sale or assignment of a performer’s economic right will be deemed profits chargeable to tax in Hong Kong, where the performance is given in Hong Kong

The Bill proposes to add a new deeming section 15(1)bb to the IRO under which sums received by a non-resident from the sale or assignment of a performer’s economic right will be deemed to be profits of the non-resident chargeable to tax in Hong Kong, where such right relates to a performance given in Hong Kong on or after the date on which the Bill is enacted into law.

Tax and withholding obligations of Hong Kong payers

The Bill proposes to make corresponding amendments to section 20B of the IRO. Under the proposed amendments, a non-resident, who has received royalties or sums referred to above, will be chargeable to tax in Hong Kong in the name of the Hong Kong payer. Furthermore, the Hong Kong payer will be required to withhold an amount sufficient to cover the tax liabilities of the non-resident in Hong Kong when they make the payment.

Registration or grant fee of plant variety rights to be tax deductible

The Bill proposes to amend the terms of section 16(1)(g) of the IRO such that sums expended for the registration or grant of a plant variety right will be tax deductible.

Effective dates

The proposed tax deduction for (i) capital expenditure incurred on the purchase of the three additional IPRs; and (ii) registration or grant fee of plant variety rights will apply to expenditure incurred or accrued during a year of assessment beginning on or after 1 April 2018.

The proposed changes to the deeming provisions contained in sections 15(1)(xb), (ba) and (bb) of the IRO will only apply to relevant amounts received or accrued on or after the date on which the Bill is enacted into law.

2. Performer’s economic right means (a) a right mentioned in section 215(1)(a), (b), (c) or (d) of the Copyright Ordinance (Cap. 25B) and conferred by Part III of that Ordinance on a performer; or (b) a right that corresponds to the right mentioned in paragraph (a) and subsists under the law of a place outside Hong Kong.

3. Protected layout-design (topography) right means (a) a right in a layout-design (topography) that is protected under section 3 of the Layout-design (Topography) of Integrated Circuits Ordinance (Cap. 445); or (b) a right that corresponds to the right mentioned in (a) and subsists under the law of a place outside Hong Kong.

4. Protected plant variety right means (a) a right granted under Part III of the Plant Varieties Protection Ordinance (Cap 490); or (b) a right that corresponds to the right mentioned in paragraph (a) and subsists under the law of a place outside Hong Kong.
Commentary

We welcome the proposal to extend the scope of the tax deduction regime to include the three additional types of IPRs. This extension should help Hong Kong position itself as an IPR hub, develop its innovation and creative industries, and drive the re-industrialization of Hong Kong.

However, the anti-avoidance provision contained in section 16EC(4)(b) will deny a tax deduction where a relevant IPR is wholly or principally used outside Hong Kong by a person other than the taxpayer under the term of a license (even on a royalty-free basis). The existence of section 16EC(4)(b) will mean that taxpayers will not be able to obtain the tax deduction for the purchase costs of the IPRs in many legitimate cases where no tax avoidance is involved.

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

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

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

We note that in a recent written response to a question raised by a lawmaker in the Legislative Council, the Secretary for Financial Services and Treasury, Mr. James Lau, has indicated that he has communicated with the industry and is re-examining the issue. We hope that when finalizing the Bill, the Government can consider excluding the application of section 16EC(4)(b) to situations like those illustrated by the example above.

In addition, given that Hong Kong will soon introduce comprehensive transfer pricing legislation for related party transactions, the disallowance for costs incurred on the purchase of IPRs from an associate under section 16EC(2) may also not be justified.

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5. Section 16EC(4)(b) is modeled on section 39E(1)(d)(i) of the IRO, the latter section has been controversially invoked by the Inland Revenue Department to deny tax depreciation allowances on capital expenditure incurred by Hong Kong taxpayers for plant or machinery provided rent-free by such taxpayers to their contract manufacturers in mainland China established under import processing arrangements, even though the profits derived by taxpayers from import processing arrangements are fully chargeable to tax in Hong Kong.

6. The question and written response of the Government can be accessed from:
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