

Tax Analysis

Authors:

Hong Kong Tax

Hong Kong

Davy Yun

Partner

Tel: +852 2852 6538

Email: dyun@deloitte.com.hk

Silent Li

Senior Manager

Tel: +852 2852 6399

Email: silli@deloitte.com.hk

Inland Revenue Department issues guidance on deduction of purchase cost of intellectual property rights

Hong Kong's Inland Revenue Department ("IRD") issued guidance on 10 July 2012 Departmental interpretation and Practice Note No. 49 ("DIPN 49")¹ that sets out the IRD's positions on several sections of the Inland Revenue Ordinance ("IRO"). These provisions in the IRO concern the deductibility of capital expenditure incurred on the purchase of "patent rights", "rights to know-how" and specified intellectual property rights ("IPRs"), i.e. copyrights, registered designs or registered trademarks.

Background

Hong Kong generally does not tax capital gains and, accordingly, a deduction is not allowed on capital expenditure unless the tax law specifically grants the deduction. For example, under existing rules, a deduction may be taken for purchase costs incurred on "patent rights" and "rights to know-how."

With a view to promoting the wider application of intellectual property by Hong Kong enterprises and developing creative industries in Hong Kong, the tax law was amended in December 2011 to expand the deduction for capital expenditure to cover more IPRs, such as copyrights, registered designs and registered trademarks ("Specified IPRs"), with effect from year of assessment 2011/12. DIPN 49 sets out the IRD's interpretation and practices in relation to:

- The profits tax deduction of capital expenditure on relevant IPRs (i.e. patent rights, rights to know-how, copyrights, registered designs and registered trademarks); and
- The taxation of royalties derived from the licensing of IPRs.

Deduction rules on acquisition costs for IPRs

1. Deduction criteria

As summarized in DIPN 49, a taxpayer will be permitted to deduct the purchase costs of a qualifying IPR if:

¹ Departmental Interpretation and Practice Notes are issued for the information of taxpayers and their tax representatives. DIPNs contain the IRD's interpretation and practices in relation to the law as it stood at the date of publication. However, DIPNs do not have binding force and a taxpayers' right to objection or appeal are not affected by the application of DIPNs.

- a. The relevant IPR subsists (in the case of copyrights or rights to know-how) or, if applicable, the registration of the relevant IPR is in force (in the case of patent rights, designs or trademarks);
- b. The taxpayer has legal and economic ownership of the relevant right at the end of the basis period;
- c. The IPR has been used in Hong Kong or by the taxpayer itself outside Hong Kong; and
- d. The relevant IPR has been used for the production of profits chargeable to tax in Hong Kong.

Registration requirement for patents, designs and trademarks

DIPN 49 states that the relevant IPRs (namely patents, designs and trademarks) must be "registered" if a registration system is in place. Registration in either Hong Kong or overseas will be recognized. DIPN 49 also states that since the registration process for IPRs in some jurisdictions may take time to complete, the IRD will adopt a liberal approach in considering whether a deduction will be allowed for IPRs undergoing registration and a deduction will be allowed provided (a) the relevant IPRs already were registered by the previous owners with the relevant authorities; and (b) the taxpayers already have submitted applications for registering the IPRs under their names.

2. Timing of the deduction

- a. A one-time deduction in the year of purchase is granted for patent rights or rights to know-how.
- b. The deduction for Specified IPRs, i.e. copyrights, registered designs or registered trademarks, is spread over the five subsequent years on a straight-line basis starting from the year of purchase.

3. Subsequent disposal

If the IPRs for which a deduction has been claimed are subsequently sold, the sale proceeds will be taxable according to the rules prescribed in the IRO. However, in any case, the taxable amount may not exceed the deductions previously allowed. In the case of copyrights, registered designs and registered trademarks, the calculation is similar to the balancing adjustments for plant and machinery. If the "unallowed" amount exceeds the proceeds of sale, the excess will be deductible. On the other hand, if the sales proceeds exceed the "unallowed" amount, the excess will be taxable.

4. A deduction will be disallowed under certain circumstances

To counteract abusive arrangements, several tax provisions will disallow a deduction in specific situations:

- Section 16EC(1): This provides that a deduction will not be allowed for Specified IPRs (i.e. copyrights, registered designs or registered trademarks) where the licensee purchases the IPRs after an early termination of the licence under certain situations. DIPN 49 states that Section 16EC(1) is a transitional measure and will not be applicable to taxpayers who have become licensees of the Specified IPRs on or after the commencement date of the new law (i.e. 16 December 2011).
- Section 16EC(2): This measure disallows a deduction if the relevant IPRs are purchased wholly or partly from an associate, irrespective of whether the price is on arm's length terms. The term "associate" is broadly defined in Section 16EC(8) to cover individuals, partners in a partnership or corporations under common control, and trusts.
- Section 16EC(4)(a): The provision will disallow a deduction in certain sale and license back arrangements.
- Section 16EC(4)(b): The provision stipulates that no deduction will be allowed for capital expenditure incurred on the purchase of the IPR if at any time the IPR is used by another person (other than the owner of the IPR) wholly or principally outside Hong Kong.
- Section 16EC(4)(c): The provision addresses leveraged licensing arrangements and denies a deduction to a taxpayer (as licensor) where all or a predominant part of the cost of the IPR was financed directly or indirectly by non-recourse debt.

Used wholly or principally outside Hong Kong by persons other than the taxpayer

The above provisions that deny deductions mirror anti-avoidance tax provisions that restrict depreciation allowance claims for plant and machinery under Section 39E of the IRO. Section 16EC(4)(b), which addresses the situation where the IPRs are used wholly or principally outside Hong Kong by persons other than the taxpayer, is controversial. For example, it is not uncommon for a Hong Kong taxpayer to contract with an overseas manufacturer (e.g. a manufacturer in Mainland China) to produce goods for itself. The overseas manufacturer is permitted to use the IPRs acquired by the Hong Kong taxpayer in the course of manufacturing and such IPRs would then be regarded as “used wholly or principally outside Hong Kong by persons other than the taxpayer”. Therefore, the acquisition costs would not be allowable even though the profits generated by the taxpayer from selling the finished goods produced by the Mainland manufacturer are subject to Hong Kong tax in full.

Examples in DIPN 49 outline the IRD’s views in this regard. In Example 15, the taxpayer purchases a trademark registered in both Hong Kong and the Mainland. Since the Mainland-registered trademark is used by persons other than the taxpayer (i.e. the Mainland manufacturer) outside Hong Kong (i.e. in the Mainland), the purchase price for the Mainland-registered trademark is not deductible. By contrast, in Example 13, the taxpayer purchases a trademark that is registered in Hong Kong but nowhere else. The taxpayer contracts with a manufacturer in the Mainland to produce goods bearing the Hong Kong trademark. When manufacturing the goods in the Mainland, what the Mainland manufacturer used is the unregistered trademark in the Mainland, so the IRD will accept the full purchase cost of the trademark as a deduction.

IRD view on taxation of royalties derived from licensing IPRs

One of the criteria for claiming a deduction for the purchase costs of IPRs is that the IPRs be used for the production of chargeable profits. If an IPR is licensed or sub-licensed out, whether the royalty income derived therefrom would be onshore and taxable (or offshore and non-taxable) will determine whether a deduction can be claimed. DIPN 49 also states the IRD’s views on taxation of royalties derived from the licensing of IPRs:

1. Where the IPR is created or developed by the licensor

If the IPR is created or developed by a taxpayer carrying on business in Hong Kong, the royalties so derived generally will be regarded as Hong Kong-source income and taxable, notwithstanding the fact that the IPR is licensed to a party outside Hong Kong. This is because the royalty income is generated primarily by the taxpayer using his ingenuity and labor to create or develop the IPR in Hong Kong.

2. Where the IPR is purchased by the licensor

If a taxpayer purchases an IPR and licenses it to another party for use outside Hong Kong, the royalties so derived generally will be considered non-Hong Kong-sourced and non-taxable.

3. Where the IPR is not owned by the licensor

If a taxpayer only obtains a license to use an IPR from the owner of the IPR and then sub-licenses the IPR to another party for use outside Hong Kong, the IRD will look at where the license was acquired and granted in order to determine the source of income.

The IRD also emphasizes that whether royalties derived from the licensing of IPRs by taxpayers carrying on business in Hong Kong are subject to tax will be a question of fact to be determined on a case-by-case basis.

Observations and comments

The recent changes to the tax law now allow a deduction for capital costs incurred for the acquisition of Specified IPRs (i.e. copyrights, registered designs or registered trademarks). While this incentive is welcome, the revised law may not attract taxpayers with international operations to relocate IPRs owned by group companies to Hong Kong entities because a deduction will be denied if the IPRs are purchased wholly or partly from an associated party.

Taxpayers will need to carefully analyze whether costs incurred on IPRs are deductible under the new law, and it is likely that the practical application of the law will not be straightforward, particularly if the following are involved:

- Partial ownership
- Registration issues
- IPRs are used partly for chargeable profits and partly for other purposes

- IPRs are registered both in and outside Hong Kong
- IPRs are used outside Hong Kong by a person other than taxpayer
- Sales and license backs, etc.

In view of the new law, taxpayers should ensure that they plan accordingly for IPRs, seek professional advice to thoroughly understand the provisions of the law and guidance issued by the IRD and how these will impact the taxpayer's position.

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Beijing

Kevin Ng

Partner
Tel: +86 10 8520 7501
Fax: +86 10 8518 7501
Email: keving@deloitte.com.cn

Hong Kong SAR

Sarah Chin

Partner
Tel: +852 2852 6440
Fax: +852 2520 6205
Email: sachin@deloitte.com.hk

Shenzhen

Constant Tse

Partner
Tel: +86 755 3353 8777
Fax: +86 755 8246 3222
Email: contse@deloitte.com.cn

Chongqing

Claude Gong

Partner
Tel: +86 23 6310 6206
Fax: +86 23 6310 6170
Email: clgong@deloitte.com.cn

Jinan

Eunice Kuo

Partner
Tel: +86 531 8518 1058
Fax: +86 531 8518 1068
Email: eunicekuo@deloitte.com.cn

Suzhou

Frank Xu / Maria Liang

Partner
Tel: +86 512 6289 1318 / 1328
Fax: +86 512 6762 3338
Email: frakxu@deloitte.com.cn
mliang@deloitte.com.cn

Dalian

Frank Tang

Partner
Tel: +86 411 8371 2888
Fax: +86 411 8360 3297
Email: ftang@deloitte.com.cn

Macau SAR

Quin Va

Partner
Tel: +853 8898 8833
Fax: +853 2871 3033
Email: quiva@deloitte.com.hk

Tianjin

Jason Su

Partner
Tel: +86 22 2320 6680
Fax: +86 22 2320 6699
Email: jassu@deloitte.com.cn

Guangzhou

Constant Tse

Partner
Tel: +86 20 8396 9228
Fax: +86 20 3888 0121
Email: contse@deloitte.com.cn

Nanjing

Frank Xu

Partner
Tel: +86 25 5791 5208
Fax: +86 25 8691 8776
Email: frakxu@deloitte.com.cn

Wuhan

Justin Zhu

Partner
Tel: +86 27 8526 6618
Fax: +86 27 8526 7032
Email: juszhu@deloitte.com.cn

Hangzhou

Qiang Lu

Partner
Tel: +86 571 2811 1901
Fax: +86 571 2811 1904
Email: qilu@deloitte.com.cn

Shanghai

Eunice Kuo

Partner
Tel: +86 21 6141 1308
Fax: +86 21 6335 0003
Email: eunicekuo@deloitte.com.cn

Xiamen

Lynch Jiang

Partner
Tel: +86 592 2107 298
Fax: +86 592 2107 259
Email: lijiang@deloitte.com.cn

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National Tax Technical Centre

E-mail: ntc@deloitte.com.cn

Eastern Region

Leonard Khaw

National Leader & Partner
Tel: +86 21 6141 1498
Fax: +86 21 6335 0003
Email: lkhaw@deloitte.com.cn

Northern Region

Angela Zhang

Partner
Tel: +86 10 8520 7526
Fax: +86 10 8518 1326
Email: angelazhang@deloitte.com.cn

Southern Region

Davy Yun

Partner
Tel: +852 2852 6538
Fax: +852 2520 6205
Email: dyun@deloitte.com.hk

If you prefer to receive future issues by soft copy or update us with your new correspondence details, please notify Wandy Luk by either email at wanluk@deloitte.com.hk or by fax to +852 2541 1911.

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