

Tax

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Tax Analysis

Proposed Expansion of Deduction for Purchase of Intellectual Property Rights

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The Inland Revenue (Amendment) (No. 2) Bill 2018 (the Bill) that would expand the scope of profits tax deduction for capital expenditures incurred for the purchase of intellectual property rights (IPRs) was introduced to the Legislative Council on 11 April 2018. The aim is to encourage the development of the intellectual property (IP) industry in Hong Kong, particularly Hong Kong as a premier IP trading hub in Asia.

Key features of the Bill

(i) Deduction of capital expenditure for purchase of three new types of IPRs

Currently, capital expenditures for purchasing specified IPRs are deductible for profits tax purposes under specified provisions. The existing five types of specified IPRs are patent rights, registered design, registered trademark, copyright and rights to industrial know-how. The Bill now proposes to add three types of IPRs (new IPRs) that can be qualified for deduction under Section 16EA of the Inland Revenue Ordinance (IRO). The three additional types of IPRs are:

Layout-design (topography) of an integrated circuit (IC)

means the three-dimensional disposition of the elements, at least one of which is an active element, and of some or all of the interconnections of an IC; or means such a three-dimensional disposition prepared for an IC intended for manufacture.

Plant variety right is the right granted to plant breeders (or owners of the variety) over cultivated plant varieties they have bred or discovered and developed.

Performer's economic right is the right of reproduction, distribution and making available to the public of copies of a fixation of the performer's performances, and the right for renting to the public copies of a sound recording of the performances. Such performances include a dramatic performance, a musical performance, a reading or recitation of a literary work, a performance of an artistic work, an expression of folklore or a performance of a variety act or similar presentation.

Capital expenditures on the purchase of the above three types of newly added IPRs will generally be allowable for deduction over five consecutive years on a straight-line basis starting from the year of purchase. The mechanism and restrictions (e.g., cannot be purchased from an associate, cannot be used by another person outside Hong Kong, etc.) are similar to the existing rules for copyright, registered design and registered trademark under Section 16EC. Subject to the enactment of legislation, the proposed provision applies to capital expenditures incurred in the year of assessment 2018/19 and onwards.

(ii) Deduction of expense for new IPRs registration

The Bill also proposes to expand the scope of deduction of registration expenses for trade mark, design or patent under Section 16(1)(g) to cover the newly added 3 types of IPRs. Subject to the enactment of legislation, the proposed provision applies to expenses incurred in the year of assessment 2018/19 and onwards.

(iii) Royalties for the use of the new IPRs

While the Bill allows deduction for capital expenditures incurred for the purchase of the new IPRs, it also amends the existing deeming provisions (Section 15(1)(b) and (ba) of the IRO) by adding these 3 types of IPRs so that sums received for the use or right to use these IPRs are deemed taxable receipts. The mechanism is the same as the existing rules for royalties on other IPRs. Subject to the enactment of legislation, the proposed provision applies to sums accrued on or after the date on which the legislation is enacted.

(iv) Sums for the assignment of performer's right

It is worth noting that the Bill contains a new provision (Section 15(1)(bb)) which deems the sums received by a performer or an organizer for the assignment of a performer's right in relation to a performance in Hong Kong as taxable. Subject to the enactment of legislation, the proposed provision applies to sums accrued on or after the date on which the legislation is enacted.

(v) Withholding obligation by Hong Kong payer

While the taxpayer is generally the non-resident recipient, the Hong Kong payer will be obliged to withhold the tax amount in respect of the royalties and sums received for the assignment of performer's right. The tax amount for royalties chargeable under Section 15(1)(b) / (ba) is calculated at an effective tax rate of 4.95% or lower under an applicable tax treaty, on the gross receipts according to Section 21A. However, Section 21A is not amended in the Bill to cover Section 15(1)(bb). In other words, the tax amount for the sums received for the assignment of performer's right will be calculated at the standard profits tax rate (16.5%) on the assessable profits.

Our comments

The new charging provision for assignment of right (Section 15(1)(bb)) only applies to performer's right, but not other IPRs. In other words, gain on transfer of other IPRs (e.g., copyright, trademark, patent etc.) may not be subject to profits tax if it is not derived from the carrying on business in Hong Kong or capital in nature or offshore sourced. However, gain on transfer of performer's right will be deemed to be

subject to profits tax, no matter it could be capital in nature. One may question what the reason is for differentiating the tax treatment of assignment of performer's right from that of other IPRs, and how this links to the government's intention to encourage Hong Kong's IP industry.

In addition, in view of the different tax treatments of assigning performer's right and copyright, it would be important to distinguish the IPRs in order to avoid tax disputes. According to the definition under IRO and Copyright Ordinance (Cap.528), copyright includes a property right which subsists in sound recordings, films, broadcasts or cable programs while performer's right includes the right of reproduction and distribution copies of a fixation of an actor, singer, musician, dancer's performances. Are there any overlapping areas for copyright and performer's right? For example, should the right to produce DVDs of a concert be classified as copyright or performer's right? These may not be clear to people in the businesses who are not experts of intellectual property law. It is suggested the Inland Revenue Department issue guidance in this area.

Another issue is the computation of the tax payable for the assignment of performer's right under Section 15(1)(bb). As mentioned above, unlike withholding tax on royalties which are calculated based on gross receipts, the tax payable for assignment of performer's right could be calculated based on profits. In other words, the non-resident taxpayer (in most cases) will need to provide the profit and loss account to the Hong Kong payer who has the obligation to withhold the tax amount. A practical issue may arise where the non-resident seller is unwilling to share the relevant financial information with the Hong Kong buyer. Would the IRD allow or suggest a deemed profit ratio for calculating the tax amount for Section 15(1)(bb) purposes?

It is generally welcomed that the government continues to introduce measures to encourage the development of creative and innovation industries, as well as enhancement of Hong Kong's position as an international IP trading hub. Nevertheless, the three additional types of IPRs are quite specific and may not cover a wide range of businesses in Hong Kong. In addition, the benefit to businesses are limited due to the restrictions on deduction under the existing regime. For example, if a Hong Kong trading company purchases an IPR and provides it to the supplier for use in the manufacturing of finished goods that subsist the IPR in the PRC, deduction of the IPR capital expenditures will be denied under Section 16EC(4)(b) of the IRO. If an IP trading company purchases and sells IPs, the cost of the IPs would normally be deductible as the cost of trading stock, not necessarily relying on the enhanced provision under the Bill. The Bill may mostly benefit cases where a company purchases an IPR from an unrelated party and further develops it for deriving onshore sourced royalties.

In order to provide a favourable tax environment for the broader IP industry in Hong Kong, the government should consider providing tax incentives on IP related income, as well as relaxing the limitation of tax deductions (e.g. research and development expenditures paid to affiliates, purchase of IPRs for use outside of Hong Kong, etc.) under the existing law.

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