

Tax

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Hong Kong Tax Analysis

Inland Revenue Department updated guidance on taxation and deduction related to intellectual property

The Inland Revenue Department (IRD) recently released the following revised Department Interpretation and Practice Notes (DIPN):

- [DIPN No. 22 \(revised\)](#) on taxation of royalties and other income from intellectual property (IP);
- [DIPN No. 49 \(revised\)](#) on profits tax deduction of capital expenditures on patent rights, rights to know-how and specified IP rights.

The DIPNs are revised mainly to reflect the legislative changes made in 2018 about expanding the scope of profits tax deduction for capital expenditure incurred for the purchase of IP rights. They replace the previous versions issued in January 2005 and July 2012 respectively.

In this Tax Analysis, we will highlight the key updates to these two revised DIPNs.

Key updates

[DIPN No. 22 \(revised\) – taxation of royalties and other income from IP](#)

Basic charge and deeming provisions

Royalty income can be chargeable to profits tax under different provisions of the Inland Revenue Ordinance (IRO):

- Basic charge – Royalty income derived by a person carrying on business in Hong Kong is chargeable to profits tax under the basic charging provision Section 14.

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- Deeming provisions – Royalty income could be deemed taxable under Sections 15(1)(a), (b) or (ba) and 21A in certain circumstances. A typical example is royalties for use of IP in Hong Kong derived by a non-resident person who does not carry on a business in Hong Kong.

The IRD clarified that if a person is chargeable to profits tax under Section 14, there is simply no need to resort to Section 15(1). It added in DIPN No. 22 (revised) that where an assessment was originally made on the basis of Sections 15 and 21A of the IRO, an additional assessment can be made if it was subsequently found that the proper charging section should be Section 14 of the IRO.

Source of royalty income under basic charge

DIPN No. 22 (revised) includes a new section on the source of royalty income, which was originally contained in the previous version of DIPN No. 49.

The IRD's view regarding the source of royalty income basically remains unchanged with certain points being clarified in the new version. While the broad guiding principle will be followed in determining the source of royalty income, the IRD added that the focus is on establishing the geographical location of the person's profit-producing transactions, not the antecedent or incidental activities. In addition, the source of profits must be attributed to the operations of the person which produce them and not to the operations of other members of the person's group. Nevertheless, the IRD reiterated that it would take the "totality of facts" approach i.e. to consider the totality of facts and circumstances in each case for determining the source of royalty income.

Scenario 1: Licensing of IP created or developed by licensor

If an IP is created or developed in Hong Kong, the royalty income derived from the IP will generally be regarded as Hong Kong sourced and subject to profits tax. This position is the same as that of the previous DIPN. The IRD clarified in the revised DIPN that the place where the IP is used is not a relevant factor to determine the source of royalty income in such situation. Accordingly, even if the IP is used outside Hong Kong, the income derived from the IP will still be considered as having a source in Hong Kong.

Scenario 2: Licensing of IP purchased by licensor

If an IP was purchased and licensed for use outside Hong Kong, the royalties derived would generally be regarded as non-Hong Kong sourced and not subject to Hong Kong tax. This position remains the same as before in general. In particular, the IRD provided in the revised DIPN a clearer example of non-Hong Kong sourced income where the purchase of IP, the licensing to another person and the use of IP are all outside Hong Kong.

Scenario 3: Sub-licensing of IP which is not owned by licensor

In ascertaining whether the royalty derived from sub-licensing of IP is sourced in Hong Kong, the IRD will take the place of acquiring and granting the licence as the location of income. If the licence for use of the IP is acquired in Hong Kong and the sub-licence is granted in Hong Kong, the royalty income derived from sub-licensing the IP will be regarded as having a source in Hong Kong. This position is the same as that of the previous version.

New deeming provisions

Revised DIPN No. 22 explains the application of certain deeming provisions introduced to the IRO in 2018, including the following:

- Section 15(1)(bb) – sums received by or accrued to a performer or an organizer for the assignment of a performer's right in relation to a performance in Hong Kong will be deemed to be trading receipts chargeable to profits tax.

- Section 15(1)(bc) – sums received by or accrued for the use outside Hong Kong of certain IP generated from any research and development (R&D) activity in respect of which a deduction is allowable under Section 16B will be deemed to be trading receipts chargeable to profits tax.
- Section 15F – sums accrued to a non-Hong Kong associate in respect of the use of IP which are attributable to the development, enhancement, maintenance, protection or exploitation (DEMPE) activities carried out in Hong Kong will be deemed to be trading receipts chargeable to profits tax.

Computation of assessable profits and application of "withholding tax rate" under a Double Taxation Agreement / Arrangement (DTA)

Profits tax on royalties derived from the use of IP in or outside Hong Kong that are deemed taxable under Section 15(1)(a), (b) or (ba) of the IRO should be withheld by the Hong Kong payer. DIPN No. 22 (revised) includes a new section on the application of DTA rates. The detailed discussions and examples included therein are useful reference for taxpayers.

- The assessable profit is generally 30% of the gross sum of royalties, hence resulting in an effective withholding tax rate of 4.95% (i.e. 30% x 16.5%¹ profits tax rate). If the IP was previously owned by a person carrying on a business in Hong Kong and the sum is paid to an associate, 100% of the gross sum is taken as the assessable profits, giving rise to an effective tax rate of 16.5%¹. This is an anti-avoidance measure to prevent abusive use of the reduced 4.95% rate in order to obtain tax benefits by entering into arrangements with overseas associates. The IRD clarified that a DTA territory resident person cannot take the benefit of paying tax at the lower rate specified in the DTA if the anti-avoidance provision is invoked. This aligns with the IRD's view expressed in its 2018 Annual Meeting with HKICPA.
- If the royalties are paid to a DTA resident person who is the beneficial owner, the rate specified in the DTA will be applicable. If the rate specified in the DTA is higher than that provided in the IRO, the lower rate of the IRO (i.e. currently 4.95%) will be applicable. Where there is a tax reduction / rebate, the lesser amount of tax payable calculated by the DTA or IRO rate after the tax reduction / rebate will be adopted.
- The IRD reminded that royalties paid in connection with a permanent establishment in Hong Kong will form part of the business income of such permanent establishment and chargeable to profits tax under section 14. In such case, the business profits article instead of the royalties article of the DTA will apply.

DIPN No. 49 (revised) – profits tax deduction of capital expenditures on patent rights, rights to know-how and specified IP rights

Scope of tax deduction

DIPN No. 49 (revised) has been updated to reflect the legislative changes made in 2018 about expanding the scope of profits tax deduction for capital expenditure incurred for the purchase of IP rights, including (1) performer's economic rights, (2) protected layout-design (topography) rights and (3) protected plant variety rights (new SIPR). Definitions and detailed descriptions of the new SIPR are added to the revised DIPN.

Conditions for deduction

The conditions for deduction of the new SIPR are similar to those applicable to copyrights, registered designs and registered trade marks and summarized as follows :

- The registration or grant of the protected plant variety right is in force, the performer's economic right has not expired, or the protection of the layout-design (topography) has not ceased at the time of purchase and during a part or the whole of the basis period.
- Upon the purchase, the person has possessed the legal and economic ownership of the new SIPR.

¹ If two-tiered profits tax rates apply, the applicable tax rate is 8.25% for the first two million of assessable profits for corporations.

- At the end of the basis period, the person has not sold the new SIPR.
- The new SIPR has been used in the production of the person's profits chargeable to tax in Hong Kong during a part or the whole of the basis period.

The deduction will be spread over 5 consecutive years (or over the remaining period of protection where appropriate). These conditions will need to be satisfied for each of the years of assessment concerned.

Our observation

We welcome the IRD updating the two DIPNs and providing a number of important clarifications. In particular, the IRD clarified that the source of profits must be attributed to the operations of the person which produce them and not to the operations of other members of the person's group. For example, if a taxpayer purchased an IP which was developed by its group company outside Hong Kong and licensed it to another person, the location where the IP was developed would be irrelevant in determining the source of royalty income because such activity was not carried out by the taxpayer.

Nevertheless, there is an uncertain issue not covered in DIPN No. 22 (revised). Section 21A of the IRO specifies the computation of assessable profits for sums deemed taxable for use of IP in or outside Hong Kong under Sections 15(1)(a), 15(1)(b) and 15(1)(ba), but not Section 15(1)(bb) regarding assignment of performer's right. As the Hong Kong payer has the obligation to withhold the relevant tax payment, it would be helpful if the IRD could clarify whether the deemed rate would be applicable or how the assessable profits in respect of the sums arising from assignment of performer's right be computed.

Although not mentioned in DIPN No. 22 (revised), two-tiered profits tax rates are applicable to the non-resident person who has no connected entity or none of its connected entity elects to be so chargeable for the relevant year of assessment. In other words, the royalties received by a non-resident could be deemed chargeable at an effective tax rate of 2.475% (i.e. 30% x 8.25%) for the first two million of assessable profits. Nevertheless, the IRD reminded in the Frequently Asked Questions section of its website that even if the non-resident person is applying the two-tiered rates for the royalties received from a Hong Kong payer, it is still possible that such payer is not the only payer who has reported assessable profits for it. Under such circumstances, at the time of payment to the non-resident person, the Hong Kong payer should withhold the amount of tax payable as if the non-resident person is not chargeable at the two-tiered rates.

Given the rapid development in the international tax landscape, digital economy and IP related tax issues are being closely reviewed. It is expected that the IRD will adopt a more stringent approach in reviewing offshore claim on IP related income and in preventing any double non-taxation situation potentially arising from Hong Kong's territorial source taxation system. Taxpayers should review their current business models based on the updated DIPNs and, where appropriate, seek professional advice on their IP related activities and arrangements accordingly.

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