HONG KONG

New Tax Deduction of Three Additional Types of Intellectual Property Rights Reignites the Controversies Surrounding Sections 16EC(4)(b) and 39E(1)(b)(i) of the Inland Revenue Ordinance

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Three New Types of Specified Intellectual Property Rights Now Eligible for Tax Deductions

The Inland Revenue (Amendment) (No. 5) Ordinance 2018 has recently been enacted to grant tax deductions for three new types of specified intellectual property rights ("IPRs"), namely performer's economic rights, protected payout-design (topography) rights, and protected plant variety rights. These new tax deductions work within the existing tax deduction regime that comprises two main provisions of the Inland Revenue Ordinance ("IRO"):[1]

- **Section 16E**, which is not affected by the new law and which grants a 100 per cent tax write-off in the year of purchase for the costs of patent rights and rights to know-how where specified conditions are satisfied.
- **Section 16E**, which after the enactment of the new law effective from the year of assessment 2018/19 extends its coverage from registered trademarks, copyrights, and registered designs to include the three new types of IPRs detailed above. Under section 16EA, tax deductions for capital expenditure incurred on the purchase of such IPRs will generally be spread over five successive years in equal instalments, beginning in the year of purchase.

Tax deductions otherwise granted under either section 16E or section 16EA will, however, be denied when the specific anti-avoidance provisions contained in section 16EC apply. Of all the specific anti-avoidance provisions in section 16EC, the one that has attracted the most controversy among tax professionals is contained in section 16EC(4)(b).

The Controversial Section

Under section 16EC(4)(b), no tax deduction will be allowed under section 16E or section 16EA if the relevant IPR is wholly or principally used outside Hong Kong by a person other than the taxpayer under the term of a licence (regardless of whether royalties are charged).

Section 16EC(4)(b) is in fact modelled on section 39E(1)(b)(i) of the IRO. Typically, the latter section has been controversially invoked by the Inland Revenue Department (IRD) to deny tax depreciation allowances on capital expenditure incurred by Hong Kong taxpayers in respect of plant or machinery provided by such taxpayers to their contract manufacturers outside Hong Kong in mainland China to use on a rent-free basis pursuant to import processing arrangements. Such denial will occur regardless of whether the profits derived by the taxpayers from the trading of goods manufactured under the import processing arrangements are fully taxable in Hong Kong.

An import processing arrangement generally takes the form of Hong Kong taxpayers buying goods manufactured by their subcontractors. The goods are manufactured by the subcontractors under specific instructions and orders placed by the Hong Kong taxpayers for specified goods. Under such an arrangement, the provision of plant or machinery by the Hong Kong taxpayers to their subcontractors is often necessary so that the subcontractors can manufacture the goods to the specifications required by the Hong Kong taxpayers.

Similar to section 39E(1)(b)(i), the controversy arising from the application of section 16EC(4)(b) is that it could affect many normal business arrangements that are not tax driven or structured with a view to avoiding tax. The following is one such typical example.

<u>Example</u>

A Hong Kong company purchases, from a third party, a layout-design (topography) right for certain integrated circuits ("IC Right") for HK$8 million, with the IC Right protected under the law of mainland China. Furthermore, the company then procures an unrelated contract manufacturer in mainland China under an import processing arrangement to produce goods on behalf of the company and in the process allows the contract manufacturer to use the IC Right royalty free. If the goods incorporating the IC Right were then sold by the company to customers in Hong Kong, the profits derived would generally be regarded as Hong Kong sourced income and fully taxable in Hong Kong.

The Tax Position Taken by the IRD

In the above example, the 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 licence 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 the IC Right of HK$8 million. 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.

Lobbying Efforts to Remove or Amend Section 16EC(4)(b)

When the new law was a legislative bill, a number of professional bodies made submissions to the Bills Committee formed to scrutinise the bill that section 16EC(4)(b) should be removed or amended such that tax deductions would not be denied in situations such as that illustrated by the above example.

In response, the Government indicated that section 16EC(4)(b) was first introduced into the IRO in 2011, when section 16EA was originally enacted, and that this legislative exercise only sought to extend the coverage of section 16EA to include the three new types of

IPRs, the terms of section 16EC(4)(b) being unaffected by the bill. As such, the Government considered that this legislation was not an appropriate platform for examining the issue of whether section 16EC(4)(b) should be removed or amended.[2]

Nonetheless, the Government also indicated that in the light of potential economic integration arising within the Greater Bay Area, the Secretary for Financial Services and the Treasury was re-examining both the section 16EC(4)(b) and section 39E(1)(b)(i) issues as raised by the submissions on the bill.

The scope of the Secretary's re-examination included exploring feasible options to address the concerns raised by the submissions while also enabling Hong Kong to comply with the principles of tax symmetry and transfer pricing.

Principles of Tax Symmetry and Transfer Pricing Referred to by the Government

Tax Symmetry

Using the above example for illustration, for tax symmetry, the issue is whether the granting of the use of the IC Right by the Hong Kong taxpayer to the contract manufacturer royalty free is for the purpose of generating (i) the manufacturing profits of the contract manufacturer in mainland China, which are not chargeable to tax in Hong Kong, or (ii) the trading profits of the taxpayer, which are fully chargeable to tax in Hong Kong.

If the argument in (i) prevails, the principle of tax symmetry would require the IRD to disallow the tax deduction for the purchase cost of the IC Right under section 16EC(4)(b), whereas if the argument in (ii) prevails, there may be no reason for applying section 16EC(4)(b) to disallow the tax deduction otherwise obtainable by the taxpayer under section 16EA.

Transfer Pricing

Regarding transfer pricing, the issue is whether the Hong Kong taxpayer in the above example should charge the contract manufacturer royalties for the use of the IC Right, regardless of whether (i) the IC Right is used by the contract manufacturer solely for the production of goods for the account of the taxpayer and (ii) any royalties so charged would likely be re-charged by the contract manufacturer back to the taxpayer by way of a corresponding equivalent increase in the price of the goods charged by the contract manufacturer.

The Government is concerned that if royalties have to be charged under the principle of transfer pricing, such royalty income of the taxpayer would normally be non-taxable, being sourced outside Hong Kong, given that the IC Right in question would be used in mainland China. As such, the purchase cost of the IC Right would also need to be disallowed under the principle of tax symmetry referred to above.

In addition, the Government is also apparently concerned that if tax deduction under section 16EA for the purchase cost of an IPR is granted in Hong Kong in situations like the above example, Hong Kong could be accused by overseas tax authorities of encouraging Hong Kong taxpayers not to charge royalties to their overseas contract manufacturers for the use of an IPR. By so doing, Hong Kong taxpayers could then be regarded as trying to avoid what would otherwise be their overseas withholding tax liabilities on their royalty income, potentially undermining the taxing rights of other overseas tax authorities.

Discussion

Principle of Tax Symmetry

In this regard, it would be relevant to discuss the recent case *ATG v. Comptroller of Income Tax* [2011] SGIBR 2 decided by the Income Tax Board of Review of Singapore.

Facts and Issue in Dispute in the ATG Case

The Appellant was a company which carried on the manufacture of certain electronic products ("the Products"). The Appellant outsourced parts of its manufacturing operations for the Products to independent subcontractors, some of which were located outside of Singapore. The business arrangement with the subcontractors with respect to the manufacturing of the Products was structured on a "buy-sell" model, where the subcontractors would procure certain components, process and assemble the components, and then sell the finished goods to the Appellant (i.e. similar to the import processing arrangements referred to above).

The Appellant placed certain plant and machinery at the subcontractors' premises for the purpose of manufacturing the Products. The Appellant claimed annual allowances in respect of the plant and machinery under sections 19(2) and 19A(1) of the Income Tax Act of Singapore. The Comptroller of Income Tax of Singapore refused the Appellant's claims by way of various assessments. The Appellant appealed to the Board.

The sole issue before the Board was whether the plant and machinery placed by the Appellant with the subcontractors for use in manufacturing processes for the Products were in use by the Appellant for its trade or business, thus entitling the Appellant to capital allowances on such plant and machinery.

Key Findings of the Board

The purpose of the sections is to provide for allowances in respect of capital expenditure on the provision of plant or machinery for the purposes of the taxpayer's trade or business.

The expression "for the purpose of trade" used in the relevant sections means "for the purpose of enabling a person to carry on and earn profits in the trade".

There must be a nexus between the expenditure incurred and the taxpayer's trade or business. This is a question of fact and in deciding it is important to consider whether the expenditure was "really incidental to the trade" or was incurred "for the purpose of earning the profits" (*Smith's Potato Estates Limited v. Bolland (Inspector of Taxes)* [1948] AC 508 at 526 cited).

Just because the expenditure also benefits a third party to some extent will not affect a finding of the purpose of the earning of profits (*Usher's Wiltshire Brewery Ltd v. Bruce* [1915] AC 433 at 469-70 cited).

On the basis of the finding of the facts of the case, including the following, the Board held that there was sufficient connection between the Appellant's trade and the capital expenditure incurred in providing the plant and machinery placed with its subcontractors:

- The plant and machinery placed with its subcontractors were used exclusively for the manufacturing of the Products ordered by the Appellant.
- The Appellant continued to own and maintain the plant and machinery; it bore repair and maintenance costs as well as depreciation costs.
- The Appellant supplied training and know-how for the operations of the plant and machinery, which contained the Appellant's proprietary design.

- Access to the plant and machinery by the subcontractors was controlled, and measures were taken to prevent counterfeiting.

Thus, the Board held the case in favour of the Appellant.

Understandably, following the case of *ATG v. CIT*, the Comptroller of Income Tax of Singapore has since generally agreed to grant tax depreciation allowances to Singapore taxpayers in respect of plant and machinery consigned by Singapore taxpayers to their contract manufacturers located outside of Singapore where the fact pattern is similar.

The outcome of the Singapore case *ATG v. CIT* therefore lends support to the argument that in the above example, the Hong Kong taxpayer's grant of the right to use the IC Right to the contract manufacturer is for the purpose of generating the trading profits of the taxpayer which are taxable in Hong Kong rather than generating the non-Hong Kong taxable manufacturing profits of the contract manufacturer in mainland China.

Thus, it appears that if Hong Kong is to follow the Singapore approach, section 16EC(4)(b) (and similarly section 39E(1)(b)(i)) could be removed or suitably amended such that the tax deduction or tax depreciation allowances otherwise obtainable under typical import processing arrangements would not be denied, whilst at the same time not affecting Hong Kong's desire to comply with the principle of tax symmetry.

Principle of Transfer Pricing

Regarding the principle of transfer pricing, the issue appears to be academic given that any royalties charged by the Hong Kong taxpayer to the contract manufacturer in the above example would likely be offset by a corresponding increase in the prices of goods charged by the contract manufacturer to the taxpayer. In other words, it is unlikely that there would be any net additional payment or receipt between the taxpayer and the contract manufacturer – regardless of whether royalties are charged or not, the respective net profits or losses of the two parties in each jurisdiction would remain the same. Continuing the above example, the calculation below illustrates the point.

Assumptions

(I) The Hong Kong company allows its unrelated contract manufacturer to use its IC Right on a "royalty-free" basis for the manufacturing of goods ordered by the Hong Kong company;

(II) the Hong Kong company pays HK$1,200,000 for the purchase of goods from the contract manufacturer; and

(III) the implicit royalty for the IC Right is HK$50,000 under the transfer pricing principle.

It may therefore be said that the single payment of HK$1,200,000 comprises two constituent elements: a grossed-up purchase price of goods of HK$1,250,000 paid by the taxpayer to the contract manufacturer, offset by the implicit royalty of HK$50,000 paid by the contract manufacturer to the taxpayer. The result is therefore a net payment of HK$1,200,000 by the taxpayer to the contract manufacturer.

The financial effect of the notion of "offsetting transactions" is analysed below.

Profit and Loss Account of the Hong Kong Company	
	HK$
Sales of goods (say)	1,500,000
Less: cost of goods sold	(1,200,000)
Gross profit level	**300,000**

Cost of goods paid to the contract manufacturer HK$1,250,000, less implicit royalty of HK$50,000 received from the contract manufacturer

Profit and Loss Account of the Contract Manufacturer	
	HK$
Sales of goods (say)	1,200,000
Less: cost of manufacturing (say)	(1,000,000)
Gross profit level	**200,000**

Grossed-up sales price of goods HK$1,250,000, less implicit royalty of HK$50,000 paid by the contract manufacturer

As shown above, whether the purchase price of goods is grossed up or not, the profit levels of both the Hong Kong taxpayer and the contract manufacturer would remain the same at HK$300,000 and HK$200,000 respectively.

In fact, given that the Hong Kong company and the contract manufacturer in this example are unrelated parties, there is fundamentally no transfer pricing issue, even if the notion of "offsetting transactions" is involved in the arrangement. The real issue here is whether such a single net payment between the taxpayer and the contract manufacturer could or should be "unbundled" to the two constituent elements discussed so as to identify the income source and overseas withholding tax liabilities of the "royalty income element" of the taxpayer which is "embedded" in the payment.

In this regard, there are some that take the view that, unlike an offsetting of two separate and distinct transactions, such an unbundling of the payment may not be warranted given that the use of the IC Right in the example is an integral part of the single transaction relating to the supply of goods.

In addition, some tax practitioners in Hong Kong are of the view that for Hong Kong tax purposes, the source of the "royalty income element" of the payment, if any exists, could also be regarded as being located in Hong Kong given that it stemmed from part of the operations undertaken in Hong Kong by the taxpayer for securing the supply of goods traded in Hong Kong. Similarly, if the Hong Kong taxpayer in the example also provided plant and machinery to the contract manufacturer, the same can also be said of the source of any implicit rental income embedded in the payment made by the taxpayer to the contract manufacturer.[3]

Furthermore, on the basis of the view that any implicit royalty or rental income generated from the provision of an IPR or plant and machinery by the taxpayer to the contract manufacturer could be regarded as being Hong Kong sourced income, there would be no issue of tax symmetry. As such, granting a tax deduction for the purchase cost of the IC Right (or tax depreciation allowances in respect of the provision of any plant and machinery) to the taxpayer would not involve Hong Kong breaching the principle of tax symmetry. In fact, under this view, any withholding taxes suffered by the taxpayer in mainland China in respect of any implicit royalty or rental would also be creditable in Hong Kong.

Should this view be not acceptable to the IRD, a possible way of resolving the tax controversies surrounding sections 16EC(4)(b) and 39E(1)(b)(i) may be for the IRD to notionally "uplift" the actual purchase price of goods paid by the taxpayer to the contract manufacturer when ascertaining the amount of taxable profits of the taxpayer in Hong Kong. Such an uplift would reflect the amount of the offshore royalties (or rentals) embedded in the payment. The calculation below illustrates the point.

Profit and Loss Account of the Hong Kong Company	
	HK$
Implicit royalty income (offshore)	50,000
Sales of goods (say)	1,500,000
Less: cost of goods sold	(1,250,000)
Gross profit level	**300,000**

Cost of goods purchased "uplifted" to reflect the implicit royalty the taxpayer would have charged the contract manufacturer for the grant of the use of the IC Right. As such, the taxable gross profit of the taxpayer would be reduced from HK$300,000 to HK$250,000, while the implicit royalty income would be accepted as non-taxable offshore income in Hong Kong.

Harmful Tax Practice – Undermining the Taxing Rights of Overseas Tax Authorities?

Unlike granting tax incentives to attract geographically mobile businesses to Hong Kong, the decision of whether to grant a tax deduction for the purchase cost of an IPR (or tax depreciation allowances in respect of plant and machinery) used outside Hong Kong pursuant to a contract manufacturing arrangement is purely a matter of how Hong Kong interprets and administers its own tax law.

As such, there would be no question of Hong Kong engaging in harmful tax practices by its application and interpretation of section 16EC(4)(b) and section 39E(1)(b)(i). Nor could the taxing rights of overseas tax authorities be undermined if the implicit royalty or rental income could be regarded as being sourced in the overseas jurisdictions concerned on the basis of their own domestic tax laws.

On the basis of the above, granting a tax deduction for the purchase cost of an IPR (or tax depreciation allowances in respect of plant and machinery) used outside Hong Kong pursuant to typical import processing manufacturing arrangements would not be against the principles of tax symmetry and transfer pricing.

Now that the new law has been enacted, taxpayers await with keen interest to see how the Secretary for Financial Services and the Treasury will take the above into consideration when he explores feasible options to resolve the controversial issues surrounding sections 16EC(4)(b) and 39E(1)(b)(i).

Endnotes

1. Full text of the Inland Revenue (Amendment) (No. 5) Ordinance 2018 can be accessed at https://www.gld.gov.hk/egazette/pdf/20182226/es12018222624.pdf

2. The response of the government is contained in the Legislative Council paper which is accessible at https://www.legco.gov.hk/yr17-18/english/bc/bc06/reports/bc0620180620cb1-1090-e.pdf

3. These tax practitioners have taken the view that there are no authoritative case law principles which necessarily require that the source of any implicit royalty or rental income must be determined by the place where the relevant plant or machinery or IPR are used. They argued that similar to interest earned on trade receivables granted on extended credit terms, which was held to be sourced from the trading operations undertaken by the taxpayer in Hong Kong (BR 20/75 and DIPN 13 referred to), such implicit royalty or rental income could also be accepted as being sourced in Hong Kong as a matter of law or practice. T