Hong Kong Institute of
Certified Public Accountants
香港會計師公會

6 July 2011

By fax (2121 0420) and by hand

Our Ref.: C/TXG, M78134

Hon Paul Chan Mo-po, MH, JP
Chairman
Bills Committee on Inland Revenue (Amendment) (No.2) Bill 2011
Legislative Council Building
8 Jackson Road, Central
Hong Kong

Dear Mr. Chan,

Inland Revenue (Amendment) (No.2) Bill 2011

Further to our submission of 15 May 2011 to the Bills Committee on the Inland Revenue (Amendment) (No.2) Bill 2011 and the Administration's response to submissions from deputations, dated 1 June and 10 June 2011, the Hong Kong Institute of CPAs ("Institute") would like to submit the further views set out below.

We are disappointed to note that the Administration is not intending to take on board most of the proposals put forward. The Institute is unable to agree with the Administration's response to our suggestion to include a deduction for the costs incurred in developing in-house intellectual property rights ("IPR") or under a cost sharing arrangement, on the basis that deductions for in-house development would be covered by research and development ("R&D"), under section 16B of the Inland Revenue Ordinance ("IRO"), and that cost sharing arrangements are prone to tax abuse.

Moreover, the Institute reiterates that the proposed anti-avoidance measures are too wide in their application and will unnecessarily inhibit the stated objective of the Bill, namely to promote the wider application of IPR by enterprises, to encourage innovation and upgrading and to facilitate development of creative industries in Hong Kong.

In addition, the Institute remains concerned at the "import" of the provisions from section 39E of IRO into the Bill. The Institute does not see any mischief in the situation where a Hong Kong IPR owner allows its contract manufacturer to use the IP outside Hong Kong to manufacture goods on its behalf, and the trading profits of the IP owner are subject to tax in Hong Kong.

Deduction for IP developed in-house

With regard to the suggestion that IP developed in-house would always qualify for a deduction as R&D, firstly, we are not convinced that this will always be the case and, secondly, any R&D must be either undertaken by the taxpayer itself or by an approved research institute. This is a limiting factor, as it seems that any significant subcontracting to a research institute which is not an approved institute

37th Floor, Wu Chung House,
213 Queen's Road East, Wanchai, Hong Kong
香港灣仔皇后大道東213號胡忠大廈37樓
Tel電話: (852) 2287 7228
Fax傳真: (852) 2865 6776
(852) 2865 6603
Website網址: www.hkicpa.org.hk
Email電郵: hkicpa@hkicpa.org.hk

will make the taxpayer ineligible for a deduction, even though the costs are incurred by the taxpayer.

The suggestion that cost sharing arrangements are prone to tax abuse is questionable and we would ask how the Administration would see such abuse arising. We understand that arm's length cost sharing arrangements are accepted in a number other tax jurisdictions including the Mainland, and are acknowledged in the OECD transfer prcing guidelines. Commercially it is not right to deny a deduction when two companies share resources to undertake a development and share the costs on a logical basis, each one owning its share of the right to the IP. If, for example, Canada Co were to perform all the R&D activities, and reimburse Hong Kong Co only on the costs incurred by Hong Kong Co, as services performed, the IP would be owned purely by Canada Co. Canada Co could then charge Hong Kong Co royalties. In all likelihood, the loss in tax revenue would be higher than if there were a cost sharing arrangement in place. The Institute is of the view that, so long as the cost sharing arrangement is set in accordance with the arm’s length principle, it would be equitable to give the deduction to the Hong Kong taxpayer on its costs incurred for developing and owning its share of the IPR.

Anti-avoidance provisions

The blanket denial of the deduction under the proposed section 16EC(4)(b), where a person hold rights as licensee under licence of the IPR, and the IPR are used wholly or principally outside of Hong Kong by a person other than the taxpayer, will lead to unfairnesses, as a number of submissions to the Bills Committee have pointed out.

The Administration's response that the provision is intended to deny a tax deduction for IPR used outside Hong Kong by a party other than the taxpayer for the production of profits not chargeable to tax in Hong Kong, is based on the view that such IPR are not used for the production of profits chargeable to tax in Hong Kong. Under the proposed section 16EA(2), a purchaser of IPR is not, in any case, eligible for a deduction if the IPR are not purchased for use in a trade, profession or business in relation to the profits of which the person is chargeable to tax in Hong Kong; so, if the Administration's position is correct, the proposed section 16EC(4)(b) should not be needed. The suggestion in its response that deleting section 16EC(4)(b) will create uncertainty, which may lead to disputes over the locality of profits in cross-border manufacturing activities is problematic. The principles for determing source are well established and there has been a good deal of case law on this subject. Seeking to legislate on this issue in a way which may not be consistent with those principles would not be helpful. Furthermore, the Administration's response on the issue of taxation of royalties (item 8 in Annex A to the Administration's letter to the Bills Committee dated 10 June) shows that this matter is far from clear cut and that there is a real possibility that a taxpayer may be taxed on royalty income while being denied a deduction for the related IPR expenditure.

The Institute also remains concerned about the proposed provisions that will allow the Commissioner to substitute his opinion of the true market value for the purchase or sale price of particular IPR, where he is of the opinion that the

consideration "does not represent the true market value of the specified [IP] right at the time of that purchase or sale" (proposed sections 16E(8) and 16EA(9) refer). An arm's length buy-sell transaction between non-associates should, in principle, be a reflection of the "true" market value and the simple statement in the Administration's response that this provision is needed "[t]o combat price manipulation" needs to be elaborated. The Institute would like to reiterate its view that the existing anti-avoidance provisions in section 61A of the IRO can be invoked to deal with the rare cases where IPR transactions between unassociated entities may be motivated by tax avoidance.

In the light of the above points, the Institute requests the Administration to reconsider the concerns that we have previously raised.

Should you have any questions on the Institute's submission, please contact me on 22877084 or at peter@hkicpa.org.hk.

Yours sincerely,

Peter Tisman
Director, Specialist Practices

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