



## **New deductions for capital expenditure on the purchase of copyrights, registered designs and registered trade marks**

The Inland Revenue (Amendment)(No. 3) Ordinance was gazetted on 16 December 2011 and enacts the 2010-11 Budget initiative to allow a deduction for capital expenditure incurred on the purchase of specified intellectual property rights (IPRs).

### **Background**

Previously, section 16E of the Inland Revenue Ordinance (IRO) only allowed a deduction for capital expenditure on the purchase of patent rights or rights to any know-how. The new legislation expands the deduction provisions to cover the acquisition of registered trademarks, copyrights and registered designs.

For the expenditure to be deductible under Section 16EA, the following conditions must be satisfied:

- IPRs for which registration systems are available (namely trademarks and designs) must be registered
- taxpayers need to have acquired the 'proprietary interest' in the specified IPRs
- the specified IPRs must be used in the production of chargeable profits
- where a specified IPR is only used partly in the production of chargeable profits, the deduction is limited to the extent that the specified IPRs are used in the production of such profits.

The deduction for the specified IPRs will be spread over five years on a straight-line basis commencing from the year of purchase. However, where the period of protection of the specified IPRs is less than five years, the deduction can be claimed in equal amounts over that number of years.

In conjunction with the introduction of these deductions, the opportunity has been taken to remove the 'use in Hong Kong' condition previously applicable to deductions for patent rights and rights to know-how to bring the provisions into line with deductions for other deductible capital assets. As such, a deduction is available where the expenditure on the IPR relates to the earning of assessable profits in Hong Kong.

Section 16EB provides that proceeds from the sale of specified IPRs will, to the extent a deduction has been previously allowed, be taxable. Section 16E has also been amended to reflect this position.

In its deliberations on the legislation, the Bills Committee of the Legislative Council sought clarification on a number of issues. Because of the complexity and technicality of the issues raised, the Inland Revenue Department has undertaken to issue further guidelines by way of a Departmental Interpretation and Practice Note. It is anticipated that the guidelines will clarify, amongst other things, how it will determine:

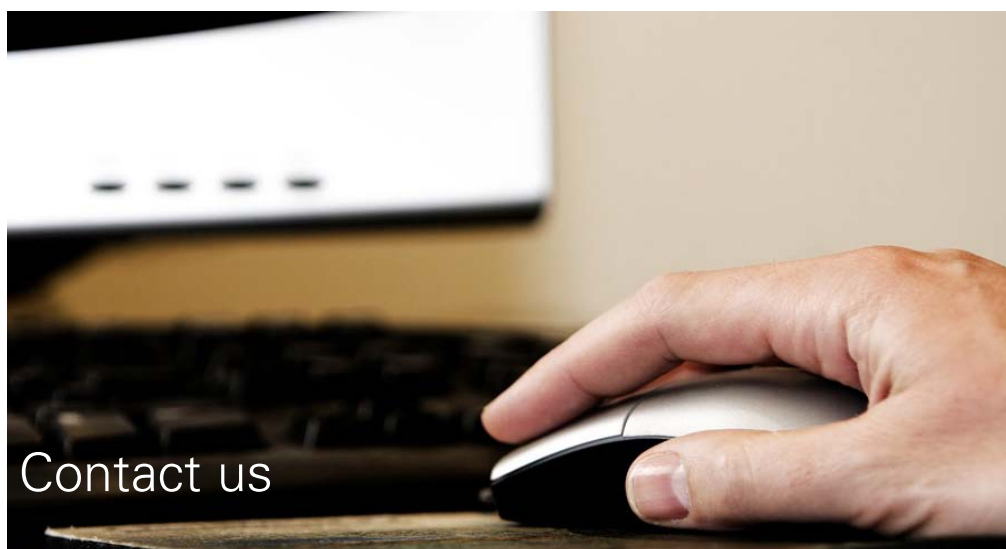
- the deductibility of the purchase of the IPRs when registration is still being processed and the claw-back arrangements for invalidated / revoked / surrendered IPR registrations
- the arrangements for determining the market value of an IPR for tax purposes
- the factors to be considered by the Commissioner in determining where there has been a sale and license back of a specified IPR
- the deductibility of capital expenditure incurred on the purchase of IPRs used in cross-border activities.

### **Comment**

The expanded deductions for capital expenditure on IPRs are welcome as it should enable taxpayers the opportunity to deduct the cost of purchasing their intellectual property rights.

The Government has also indicated that it is prepared to consider the merits of a further extension of the deduction provisions to other types of IPR in the future.

However, of concern is the anti-avoidance provision contained in Section 16EC(4)(b), which mirrors Section 39E of the IRO. No deduction will be allowable where the relevant IPR is used wholly or principally outside Hong Kong by a person other than the taxpayer under a licensing arrangement. This will give rise to deductibility issues, similar to that which exists under import processing arrangements where the Hong Kong company provides the IPR to a mainland manufacturer in connection with the production of goods. A Hong Kong company providing a specified IPR at no cost to a mainland manufacturer to produce goods for sale by the Hong Kong company may not receive a deduction for the purchase price of the specified IPR. This is notwithstanding whether or not the Hong Kong company would be fully taxable on the profits derived from the sale of the manufactured goods.



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