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Tax alert

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Specified intellectual property rights

The Inland Revenue Department (IRD) has released Departmental interpretation & Practice Note No. 49 (DIPN 49) outlining their views on the interpretation of Sections 16EA, 16EB and 16EC of the Inland Revenue Ordinance (IRO). These sections were introduced by the Inland Revenue (Amendment) (No. 3) Ordinance 2011 to give effect to the 2010-11 Hong Kong Budget initiative to allow a deduction for capital expenditure incurred on the purchase of specified intellectual property rights (IPRs) – namely copyrights, registered designs or registered trade marks.

Background

Background to the Inland Revenue (Amendment) (No. 3) Ordinance 2011 can be found in Tax alert Issue 1 – January 2012. In brief, this amendment has expanded the previous deduction for capital expenditure on the purchase of patent rights or rights to any know-how to include the acquisition of copyrights, registered designs and registered trade marks.

The DIPN reflects the undertaking given to the Legislative Council by the IRD to issue guidelines clarifying how it will determine:

- the deduction available for the purchase of IPRs when registration is still being processed and the claw-back arrangements for invalidated / revoked / surrendered IPR registrations
- the arrangements for determining for tax purposes, the true market value of an IPR
- 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
- The licensing of IPRs for use outside Hong Kong
- IPRs with registration in multiple jurisdictions.

Capital expenditure incurred on the purchase of patents and know-how is deductible in full in the year of purchase. However, expenditure on the purchase of copyrights, registered designs and registered trade marks is deductible in equal instalments over five years, commencing from the year of purchase.

Comment

Much of the focus of the DIPN is given over to the anti-avoidance aspects of the new legislation, reflecting the Government's intention to guard against potential abuses of the deductions. The most controversial provision relates to the use of an IPR outside Hong Kong, which mirrors Section 39E of the IRO. Where the relevant IPR is used wholly or principally outside Hong Kong by a person other than the taxpayer under a licensing arrangement, no deduction will be available. Under an import processing arrangement, a Hong Kong company may provide an IPR at no cost to a mainland manufacturer to manufacture goods for its resale. Section 16EC(4)(b) will deny a deduction for the purchase price of the specified IPR, notwithstanding that the Hong Kong company is fully taxable on the profits derived from the sale of the manufactured goods.

On the basis that trade marks are territorial, the IRD considers that a trade mark registered in more than one jurisdiction, results in different marks. Accordingly where a trade mark registered in a particular jurisdiction is not used in a particular year, no deduction will be available (see Example 5 of DIPN 49).

The DIPN makes it clear that a deduction for capital expenditure incurred on the purchase of IPRs, which have a registration system in place (i.e. patents, registered designs and registered trade marks), will only be available where the IPR has already been registered by the previous owners with the relevant authorities; and the taxpayer has already submitted an application for registering the IPRs in their names. Moreover, the taxpayer must possess both the legal and economic ownership in the IPR purchased. That is, a deduction will not be available where the taxpayer pays an upfront fee to acquire the right to use the IPR for a specified period.

In the case of an IPR created or developed by a taxpayer carrying on business in Hong Kong, which is licensed to another party for use outside Hong Kong, the IRD considers that the royalties are generally sourced in Hong Kong and subject to Profits Tax. The IRD considers that the royalty income is primarily generated by the taxpayer from his expertise and labour to create or develop the IPR in Hong Kong. In such situations, expenditure incurred in creating or developing the IPR is likely to be deductible under section 16B of the IRO as expenditure on research and development.

In Part B of the DIPN, the IRD expands on its views on the source of royalty income, which it states in DIPN 21 is the place of acquisition and granting of the licence or right of use.

Where a taxpayer purchases the proprietary interest of an IPR and licenses that IPR to another party for use outside Hong Kong, the IRD considers that the royalties so derived will generally be regarded as non-Hong Kong sourced and not be subject to Profits Tax. Accordingly, no deduction will be allowed for the capital expenditure incurred on acquiring the IPR.

Where a taxpayer does not obtain the proprietary interest of the IPR, but only obtains a licence to use it from its owner and then the IPR to another party for use outside Hong Kong, the IRD will look at the place of acquiring and granting the licence to ascertain whether the royalties have a Hong Kong source.

DIPN 49 can be viewed here:
http://www.ird.gov.hk/eng/pdf/e_dipn49.pdf

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