The IRD’s updated guidance on the tax treatments of income and capital expenditures related to intellectual properties

August 31, 2020
Issue 13

In brief

On August 11, 2020, the Inland Revenue Department (IRD) issued revised Departmental Interpretation and Practice Notes (DIPN) No. 22¹ and 49² in relation to the profits tax treatments of income and capital expenditures arising from intellectual properties (IPs).

The DIPNs were mainly revised to reflect the recent tax legislative amendments and case law in relation to IPs and provide more comprehensive guidance on taxation of royalty income in Hong Kong.

This news flash summarises the key updates in the two revised DIPNs and share our observations on the revisions made.

In detail

Key updates in revised DIPN 22

Below is a summary of the key updates in the revised DIPN 22 on “Taxation of royalties and other income from intellectual properties”:

• Instead of focusing on section 21A of the Inland Revenue Ordinance (IRO) which deals with the computation of the royalty amount deemed to be taxable under section 15(1), the revised DIPN 22 explains that royalty income can be chargeable to profits tax in Hong Kong under either the basic charging section (i.e. section 14) or the deeming provisions (i.e. section 15(1) and 15F) of the IRO.

• Section 15(1) does not exclude any person from chargeability to profits tax under the basic charge but simply extends the scope of section 14.

• Royalty income derived by a person carrying on a business in Hong Kong from IPs through licensing operations undertaken in Hong Kong is chargeable to profits tax under section 14 instead of the deeming provisions under section 15(1).

• The IRD’s guidance on determining the source of royalty income under section 14 as contained in Part B of the previous version of DIPN 49 has now been moved to the revised DIPN 22. The IRD emphasises
that the source of royalty is to be determined by the totality of facts and that the guidance in the revised DIPN merely illustrates how the IRD would apply the broad guiding principle in the following three situations:

1. **licensing of IPs created or developed by licensor** – the IRD’s view remains unchanged (i.e. the source is determined by the place where the IP is created or developed). Besides, the IRD has now explicitly mentioned that in this situation, the place where the licensee uses the IP is not a relevant factor to determine the source;

2. **licensing of IPs purchased by licensor** – in the revised example for this situation, the IP is purchased outside Hong Kong and licensed to another person outside Hong Kong in addition to the fact that it is used outside Hong Kong (as in the example in the previous DIPN). It seems to imply that instead of just looking at the place of use, the IRD will also look at the place of purchase and licensing of the IP to determine the source of royalty income derived from a purchased IP; and

3. **sublicensing of intellectual properties** – the IRD’s view remains unchanged (i.e. the source is the place of acquiring and granting the licence).

- There are a few new paragraphs on section 15F that applies from year of assessment 2019/20. The IRD explains that section 15F was enacted to give effect to the relevant guidance in the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations in relation to intangibles. The rationale is that a person who performs any part of the DEMPE (i.e. development, enhancement, maintenance, protection or exploitation) functions in Hong Kong in relation to an IP can be regarded as the economic owner of the IP and therefore should be subject to profits tax in Hong Kong for the part of sum derived by its non-Hong Kong resident associate from the IP that is attributable to the value creation contributions in Hong Kong.

- Updates have also been made to the DIPN to reflect two new deeming provisions in the IRO: section 15(1)(bb) dealing with assignment of performer’s right and section 15(1)(bc) dealing with royalties derived from IPs generated from research and development activities in Hong Kong.

- A new section on “DTA territory resident person” has been added to discuss: (1) the interaction between the Royalty article in a double tax agreement (DTA) of Hong Kong and the domestic IRO provisions (including the specific anti-avoidance provision in section 21A), (2) the application of the Business profits article in a DTA and section 14 of the IRO when the royalties derived by a DTA territory resident person arise through a permanent establishment in Hong Kong and (3) that the one-off profits tax reduction for a given year of assessment (if any) does not apply in computing the profits tax payable under a DTA of Hong Kong.

**Key updates in revised DIPN 49**

Below is a summary of the key updates in the revised DIPN 49 which deals with the profits tax deduction of capital expenditures incurred on IPs:

- Most updates in the DIPN are consequential changes to reflect the expansion of scope of profits tax deduction for “specified intellectual property rights” to cover three more types of IP rights, namely (1) the performer’s economic rights, (2) the protected layout-design (topography) rights and (3) the protected plant variety rights.

- One of the conditions for deduction of capital expenditures on IPs is the IPs must be purchased for use in the production of the purchaser’s profits chargeable to tax in Hong Kong. The revised DIPN clarifies that the word “use” encompasses the use of IPs in the operations, such as manufacturing or trading, or their licensing.

- An example has been added to the revised DIPN to make it clear that in the case where a Hong Kong company purchased an IP and allowed its overseas sub-contractor to use the IP outside Hong Kong for the subcontractor’s production activities at no cost, the deduction of the capital expenditure on the IP would be denied in accordance with the tax symmetry principle (i.e. the royalty income derived by the Hong Kong company, if any, could be sourced outside Hong Kong and not taxable).
The takeaway

With the complex rules for profits tax deduction of capital expenditures incurred on purchase of IPs and the increased focus on the taxation of income derived from IPs by tax administrations in general, Hong Kong companies that plan to acquire an IP or engage in IP licensing activities should take note of the revised DIPNs 22 and 49 and consider what can be the most tax-efficient IP structuring model.

As far as tax deduction for capital expenditures incurred on acquisition of IPs is concerned, we suggest that the HKSAR Government consider expanding the existing scope of such tax deduction to cover capital expenditures incurred by taxpayers to acquire other intangibles as well, such as sums paid to acquire a licence or franchise for running a business, a right to use certain radio spectrum, or an indefeasible right to use certain capacity of telecommunication cables (collectively known as “black hole expenditures”), as long as the intangibles are used in producing profits chargeable to tax in Hong Kong.

Endnotes

1. The revised DIPN 22 on “Taxation of royalties and other income from intellectual properties” can be accessed via this link: https://www.ird.gov.hk/eng/pdf/dipn22.pdf

2. The revised DIPN 49 on “Profits tax deduction of capital expenditures on patent rights, rights to know-how and specified intellectual property rights” can be accessed via this link: https://www.ird.gov.hk/eng/pdf/dipn49.pdf
Let's talk

For a deeper discussion of how this impacts your business, please contact:

PwC’s Corporate Tax Leaders based in Hong Kong

Charles Lee  
+852 2289 8899  
charles.lee@cn.pwc.com

Jeremy Ngai  
+852 2289 5616  
jeremy.cm.ngai@hk.pwc.com

Jeremy Choi  
+852 2289 3608  
jeremy.choi@hk.pwc.com

Rex Ho  
+852 2289 3026  
rex.ho@hk.pwc.com

Cecilia Lee  
+852 2289 5690  
cecilia.sk.lee@hk.pwc.com

Jenny Tsao  
+852 2289 3617  
jenny.np.tsao@hk.pwc.com

Kenneth Wong  
+852 2289 3822  
kenneth.wong@hk.pwc.com
In the context of this News Flash, China, Mainland China or the PRC refers to the People’s Republic of China but excludes Hong Kong Special Administrative Region, Macao Special Administrative Region and Taiwan Region.

The information contained in this publication is for general guidance on matters of interest only and is not meant to be comprehensive. The application and impact of laws can vary widely based on the specific facts involved. Before taking any action, please ensure that you obtain advice specific to your circumstances from your usual PwC’s client service team or your other tax advisers. The materials contained in this publication were assembled on August 31, 2020 and were based on the law enforceable and information available at that time.

This News Flash is issued by the PwC’s National Tax Policy Services in Mainland China and Hong Kong, which comprises of a team of experienced professionals dedicated to monitoring, studying and analysing the existing and evolving policies in taxation and other business regulations in China, Hong Kong, Singapore and Taiwan. They support the PwC’s partners and staff in their provision of quality professional services to businesses and maintain thought-leadership by sharing knowledge with the relevant tax and other regulatory authorities, academies, business communities, professionals and other interested parties.

For more information, please contact:

Long Ma
+86 (10) 6533 3103
long.ma@cn.pwc.com

Please visit PwC’s websites at http://www.pwccn.com (China Home) or http://www.pwchk.com (Hong Kong Home) for practical insights and professional solutions to current and emerging business issues.