



**Inland Revenue Department**

The Government of the Hong Kong Special Administrative Region  
of the People's Republic of China

**DEPARTMENTAL INTERPRETATION AND PRACTICE NOTES**

**NO. 49 (REVISED)**

**PROFITS TAX DEDUCTION OF CAPITAL EXPENDITURES ON  
PATENT RIGHTS, RIGHTS TO KNOW-HOW AND  
SPECIFIED INTELLECTUAL PROPERTY RIGHTS**

These notes are issued for the information of taxpayers and their tax representatives. They contain the Department's interpretation and practices in relation to the law as it stood at the date of publication. Taxpayers are reminded that their right of objection against the assessment and their right of appeal to the Commissioner, the Board of Review or the Court are not affected by the application of these notes.

These notes replace those issued in July 2012.

WONG Kuen-fai  
Commissioner of Inland Revenue

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# **DEPARTMENTAL INTERPRETATION AND PRACTICE NOTES**

## **No. 49 (REVISED)**

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## **INTRODUCTION**

### ***Relevant Legislation***

The Inland Revenue Ordinance (the Ordinance) has been amended several times since 1983 to allow deduction of capital expenditures incurred on the purchase of different types of intellectual property rights (IPRs) to promote their wider application in Hong Kong.

2. Section 16E, which was enacted in 1983 and amended in 1992 and 2011, relates to the deduction of capital expenditures incurred on the purchase of patent rights and rights to any know-how.

3. Sections 16EA, 16EB and 16EC of the Ordinance, which were enacted in 2011, relate to the deduction of capital expenditures incurred on the purchase of copyrights, registered designs and registered trade marks. The scope was expanded in 2018 to cover performer's economic rights, protected layout-design (topography) rights and protected plant variety rights.

4. This Departmental Interpretation and Practice Note (DIPN) sets out the views and practices of the Department regarding the deduction of capital expenditures on patent rights, rights to know-how, copyrights, performer's economic rights, protected layout-design (topography) rights, protected plant variety rights, registered designs and registered trade marks.

## **SCOPE OF THE TAX DEDUCTION**

5. IPRs are intangible assets, representing the exclusive rights offered by law to protect a person's creation. While section 17(1)(c) of the Ordinance generally prohibits the deduction of any expenditure of a capital nature, specific provisions in sections 16E and 16EA allow the deduction of capital expenditures incurred on the purchase of:

- (a) patent rights and rights to any know-how; and
- (b) copyrights, performer's economic rights, protected layout design (topography) rights, protected plant variety rights, registered designs or registered trade marks (collectively referred to as specified intellectual property rights (SIPRs)).

6. Section 16E of the Ordinance provides that, subject to the satisfaction of the prescribed conditions, any capital expenditure incurred by a person on the purchase of patent rights or rights to any know-how, for use in his trade, profession or business in the production of chargeable profits is allowable for deduction. Section 16EA provides a similar deduction for capital expenditure incurred on the purchase of SIPRs.

7. Deduction of the capital expenditure incurred on purchase would be allowed only if it can be substantiated that the right concerned constitutes a patent right, a right to know-how or an SIPR. Thus, in determining whether a right falls within the scope of deduction as defined by the Ordinance, the Assessor would make reference to the relevant statutory registration regime, if one exists, which provides an effective means to ascertain the nature of the right concerned (i.e. a patent right, a protected plant variety right, a registered design or a registered trade mark). If a registration system does not exist for the right in question (i.e. a right to know-how, a copyright, a performer's economic right or a protected layout-design (topography) right), the relevant agreement for sale and purchase will be examined so as to ascertain the precise nature of the subject matter purchased.

## **PATENT RIGHTS, RIGHTS TO KNOW-HOW AND SPECIFIED INTELLECTUAL PROPERTY RIGHTS**

### ***Patent rights***

8. A patent gives its inventor and owner a legal right to prevent others from manufacturing, using, selling or importing the patented invention. A patent is, in effect, a limited property right that a jurisdiction grants to the inventor in exchange for his agreement to share the details of the invention with the public. Registration and protection of patents operate on a territorial basis. A patent being an exclusionary right must be “registered” with the jurisdiction of such right. The term “patent rights” is defined in section 16E(4) of the Ordinance to mean the right to do or authorize the doing of anything which would, but for that right, be an infringement of a patent. Thus, in relation to a jurisdiction, any invention not registered with the jurisdiction does not fall within the term “patent rights” and it is pertinent that deduction will only be allowed for the purchase cost of patent rights in respect of which grants from the relevant authorities have been obtained.

### ***Rights to know-how***

9. Trade secrets, also described as “know-how” or “show-how”, are protected commercially by maintaining secrecy within the business enterprises and by the use of confidentiality agreements. There is no statutory registration for them. The term “know-how” is defined in section 16E(4) of the Ordinance to mean any industrial information or techniques likely to assist in the manufacture or processing of goods or materials. As a result of this definition, the deduction is confined to trade secrets and confidential information which are related to a manufacturing process.

### ***Specified intellectual property rights***

#### *Definition*

10. The term “specified intellectual property right” is defined in section 16EA(11) of the Ordinance to mean a copyright, performer’s economic right, protected layout-design (topography) right, protected plant variety right, registered design or registered trade mark (i.e. SIPRs).

#### *Copyrights*

11. “Copyright” is defined to mean:

- (a) a copyright within the meaning of section 2(1) of the Copyright Ordinance (Cap. 528) (CO), including an unregistered corresponding design as defined by section 87(5)(b) of that Ordinance; or
- (b) any right that subsists under the law of a place outside Hong Kong in any work in which a copyright referred to in sub-paragraph (a) may subsist and corresponds to a copyright referred to in sub-paragraph (a).

12. According to section 2 of the CO, “copyright” is a property right which subsists in the following descriptions of work:

- (a) original literary, dramatic, musical or artistic works;

- (b) sound recordings, films, broadcasts or cable programmes; and
- (c) the typographical arrangement of published editions.

Copyright is an automatic right which arises when a work is created and recorded in some way (e.g. on paper or electronically). Unlike patents, plant varieties, designs and trade marks, there is no registration regime for copyright works in most of the jurisdictions including Hong Kong.

*Performer's economic rights*

- 13. “Performer’s economic right” is defined to mean:
  - (a) a right mentioned in section 215(1)(a), (b), (c) or (d) of the CO and conferred by Part III of that Ordinance on a performer; or
  - (b) a right that corresponds to the right mentioned in sub-paragraph (a) and subsists under the law of a place outside Hong Kong.
- 14. According to section 200(2) of the CO, “performance” means:
  - (a) a dramatic performance (which includes dance and mime);
  - (b) a musical performance;
  - (c) a reading or recitation of a literary work;
  - (d) a performance of an artistic work;
  - (e) an expression of folklore; or
  - (f) a performance of a variety act or any similar presentation,

which is, or so far as it is, an unfixed performance given by one or more individuals.

- 15. Section 200(2) of the CO further defines “performer” to mean an actor, singer, musician, dancer or any other person who acts, sings, delivers, declaims, plays in, interprets, or otherwise performs a performance.

16. A performer's rights in his performance are independent of:
- (a) any copyright in, or moral rights relating to, any work performed or any film or sound recording of, or broadcast or cable programme including, the performance; and
  - (b) any other right or obligation arising otherwise than under Part III of the CO.

17. Performers are recognized for the pivotal role they play in the creative process in presentations to the public. The CO confers rights on performers which enable them to prohibit the exploitation of their performances without their consent. The following rights conferred under section 215(1) on a performer are performer's economic rights:

- (a) the right of reproduction;
- (b) the right of distribution;
- (c) the right of making available to the public; and
- (d) the rental right.

These property rights are assignable. Similar to copyrights, performer's economic rights are automatic rights which arise when the performance is given and registration is not required.

#### *Protected layout-design (topography) rights*

18. “Protected layout-design (topography) right” is defined to mean:
- (a) a right in a layout-design (topography) that is protected under section 3 of the Layout-design (Topography) of Integrated Circuits Ordinance (Cap. 445); or
  - (b) a right that corresponds to the right mentioned in sub-paragraph (a) and subsists under the law of a place outside Hong Kong.

19. Layout-design (topography) is defined in section 2 of the Layout-design (Topography) of Integrated Circuits Ordinance to mean the 3-dimensional disposition, however expressed, of the elements of an integrated circuit (at least one of which is an active element) and of some or all of the interconnections of an integrated circuit, or such a 3-dimensional disposition prepared for an integrated circuit intended for manufacture.

20. Rights in layout-design (topography) subsist immediately when the layout-design (topography) is created. The protection is automatic and registration is not required. However, to enjoy the protection, a layout-design (topography) must be original, and recorded in documentary form or incorporated into an integrated circuit. A qualified owner has the right to reproduce or commercially exploit his protected layout-design (topography).

*Protected plant variety rights*

21. “Protected plant variety right” is defined to mean:

- (a) a right granted under Part III of the Plant Varieties Protection Ordinance (Cap. 490); or
- (b) a right that corresponds to the right mentioned in sub-paragraph (a) and subsists under the law of a place outside Hong Kong.

22. Plant variety rights are rights granted to plant breeders (or owners of the variety) over cultivated plant varieties they have bred or discovered and developed. The Plant Varieties Protection Ordinance provides owners of plant varieties with the legal means to apply for proprietary rights over plant varieties they have bred or discovered and developed. A grantee of plant variety right has the exclusive right to produce for sale, to offer for sale or sell and to import or export reproductive material of the protected variety, to propagate the variety for commercial production of fruit or flowers and to license others to carry out any of the above activities.

23. The Plant Varieties Protection Ordinance covers all types of plants (e.g. food crops, vegetables, ornamentals) except inedible algae and inedible fungi. To be eligible for protection, the plant variety needs to be new, distinct, stable and homogenous.

*Registered designs*

24. “Registered design” is defined to mean a design registered under section 25 of the Registered Designs Ordinance (Cap. 522) or under the law of any place outside Hong Kong. Under the Registered Designs Ordinance, a “design” means features of shape, configuration, pattern or ornament applied to an article by any industrial process, being features which in the finished article appeal to and are judged by the eye. Designs registered under the Registered Designs Ordinance enjoy the protection afforded by that Ordinance in Hong Kong.

*Registered trade marks*

25. “Registered trade mark” is defined to mean a trade mark registered under section 47 of the Trade Marks Ordinance (Cap. 559) or under the law of any place outside Hong Kong. Under the Trade Marks Ordinance, a “trade mark” means any sign which is capable of distinguishing the goods or services of one undertaking from those of other undertakings and which is capable of being represented graphically. A trade mark may consist of words (including personal names), indications, designs, letters, characters, numerals, figurative elements, colours, sounds, smells, the shape of goods or their packaging and any combination of such signs. A trade mark serves as a badge of trade origin. Registration for trade marks provides legal protection in the jurisdictions or territories where they are registered. Trade marks are registered for use in one or more specific classes of goods and services.

## **QUALIFYING EXPENDITURE**

26. Sections 16E(1A) and 16EA(11) provide that capital expenditures incurred on the purchase of patent rights, rights to know-how and SIPRs including legal expenses and valuation fees incurred in connection with the purchase, are deductible. However, no deduction will be granted for any expenditure which is allowable as a deduction under Part 4 of the Ordinance. Under section 16(1)(g), capital expenditure relating to registration of a trade mark or design, or the registration or grant of a patent or plant variety right is specifically allowed for deduction.

27. For any patent right, right to know-how or SIPR generated from the research and development (R&D) activities of a person, no deduction will be

allowable to the person under section 16E or 16EA because such patent right, right to know-how or SIPR was not purchased by the person. If a project for the development of the intellectual property can be identified, the capital expenditure incurred on such a project may qualify for 100% tax deduction or enhanced tax deduction under section 16B of the Ordinance as R&D expenditure. For details, refer to DIPN No. 55 *Deduction for Research and Development Expenditure*.

### Example 1

*Company-HK purchased a patent registered in the United States at a consideration of \$1,000,000. To enjoy protection in Hong Kong, Company HK applied for registering the US patent in Hong Kong at a cost of \$50,000. Subsequently, Company-HK spent \$2,000,000 on an R&D project in Hong Kong by using that US patent. A new patent was generated by the project and the relevant registration cost in Hong Kong was \$100,000.*

The capital expenditure of \$1,000,000 incurred on the purchase of the US patent would be deductible under section 16E if it was used for the production of chargeable profits. However, no deduction under section 16E would be allowed for the new patent that was patented in Hong Kong because the patent was not purchased by Company-HK. The R&D expenditure of \$2,000,000 in relation to the new patent might be deductible under section 16B if the prescribed conditions were fulfilled. The costs of registration, \$50,000 and \$100,000, in Hong Kong of the US patent and the new patent would be deductible under section 16(1)(g) if the two patents were used for the production of chargeable profits.

## **TIMING OF DEDUCTION**

### ***One-off deduction in the year of purchase***

28. For patent rights or rights to know-how, a full deduction is allowable under section 16E(1) for the year of assessment in the basis period for which the expenditure is incurred. There is no requirement that the patent right or right to know-how, once acquired, must be used in the production of chargeable profits

in the year of purchase. It is sufficient that at the time of purchase the purpose of acquiring the patent right or right to know-how was for use in the trade, profession or business carried on in Hong Kong. However, withdrawal of the deduction may have to be considered if the subsequent facts prove otherwise.

***Deduction over 5 years or remaining period of protection***

29. For SIPRs, section 16EA(3) provides that deduction of the capital expenditure is to be allowed by 5 equal amounts over 5 consecutive years starting from the year of assessment in the basis period for which the capital expenditure is incurred (i.e. year of purchase). The deduction is, however, subject to section 16EA(6)(a) which provides that a deduction is allowable to a person only if the purchased SIPR has been used in the trade, profession or business in the production of the person's chargeable profits during a part or the whole of the basis period for a year of assessment for which an amount is deducted. For example, if a purchased registered trade mark is put to use in the 4th year, deduction cannot be claimed for the amount of capital expenditure spread over for the years before the 4th year. Only the amount of capital expenditure spread over for the 4th year and the 5th year would be allowable provided that all the prescribed conditions for deduction are fulfilled. In the extreme case where a purchased SIPR is not used until 5 years after its purchase, no deduction will be granted.

30. If the SIPR reaches the end of its finite life within the prescribed 5-year spread-over period, the deduction is to be spread under section 16EA(4) over the years of assessment from the year of purchase to the year in which the right expires in equal amounts.

**Example 2**

*Company-HK purchased a copyright at a consideration of \$400,000 during the basis period for the year of assessment 2019/20. The maximum period of protection for which the copyright could subsist was due to expire during the basis period for the year of assessment 2022/23.*

The deductible amount would be allowed by 4 equal amounts (i.e.  $\$400,000 \div 4 = \$100,000$ ) for each of the 4 years of assessment 2019/20 to 2022/23 if the other deduction criteria were fulfilled for each of the years of assessment concerned.

### Example 3

*Facts are the same as Example 2 but the maximum period of protection for which the copyright could subsist was due to expire during the basis period for the year of assessment 2019/20 (i.e. the year of purchase).*

The consideration of \$400,000 for the purchase of the copyright would be fully deductible in the year of assessment 2019/20 if the other conditions for deduction were fulfilled.

### ***Maximum period of protection***

#### *Copyrights*

31. In the case of a copyright, the maximum period of protection means the maximum period for which the copyright may subsist under the CO or may subsist under the law of a place outside Hong Kong.
32. Sections 17 to 21 of the CO provide for the duration of copyright as follows:
  - (a) copyright in a literary, dramatic, musical or artistic work expires:
    - (i) in the case with known authorship, at the end of the period of 50 years from the end of the calendar year in which the author dies; or
    - (ii) in the case with unknown authorship, at the end of the period of 50 years from the end of the calendar year in which the work was first made; or if during that period the work is made available to the public, 50 years from the end of the calendar year in which it is first so made available;
  - (b) copyright in a sound recording expires at the end of the period of 50 years from the end of the calendar year in which it is made; or if during that period it is released, 50 years from the end of the calendar year in which it is released;

- (c) copyright in a film expires at the end of the period of 50 years from the end of the calendar year in which the death occurs of the last to die of the following persons:
  - (i) the principal director;
  - (ii) the author of the screenplay;
  - (iii) the author of the dialogue; or
  - (iv) the composer of music specially created for and used in the film;
- (d) copyright in a broadcast or cable programme expires at the end of the period of 50 years from the end of the calendar year in which the broadcast was made or the programme was included in a cable programme service; and
- (e) copyright in a typographical arrangement of a published edition expires at the end of the period of 25 years from the end of the calendar year in which the edition was first published.

*Performer's economic rights*

33. In the case of a performer's economic right, the maximum period of protection means the maximum period for which the right may be conferred under the CO or may subsist under the law of a place outside Hong Kong. According to section 214 of the CO, right in a performance expires at the end of the period of 50 years from the end of the calendar year in which the performance takes place; or if during that period a fixation of the performance is released, 50 years from the end of the calendar year in which the fixation is released.

*Protected layout-design (topography) rights*

34. In the case of a protected layout-design (topography) right, the maximum period of protection means the maximum period for which the layout-design may be protected under the Layout-design (Topography) of Integrated Circuits Ordinance or may subsist under the law of a place outside Hong Kong.

35. According to section 6 of the Layout-design (Topography) of Integrated Circuits Ordinance, if a layout-design (topography) has not been commercially exploited anywhere in the world, the term of the protection will end 15 years after the end of the year in which it was created. On the other hand, if a layout-design (topography) has been commercially exploited anywhere in the world, the term of the protection will end 10 years after the end of the year in which it was first commercially exploited.

*Protected plant variety rights*

36. In the case of a protected plant variety right, the maximum period of protection means the maximum period for which the grant of the right may be in force under the Plant Varieties Protection Ordinance or may subsist under the law of a place outside Hong Kong. According to section 22 of the Plant Varieties Protection Ordinance, a grant under that Ordinance is in force for a term of 25 years in the case of trees and vines and of 20 years in other cases.

*Registered designs*

37. In the case of a registered design, the maximum period of protection means the maximum period for which the design may be registered under the Registered Designs Ordinance or under the law of a place outside Hong Kong. According to section 28 of the Registered Designs Ordinance, the initial period of registration of a design is 5 years beginning on the filing date of the application for registration and may be renewed for further periods of 5 years each. However, the total period of registration of a design may not exceed 25 years.

*Registered trade marks*

38. According to section 49 of the Trade Marks Ordinance, a trade mark shall be registered for a period of 10 years beginning on its date of registration and may be renewed for further periods of 10 years. Unlike the other SIPRs, protection of a trade mark can be perpetual provided that registration is renewed every 10 years.

***Capital expenditure incurred prior to commencement of business***

39. Where capital expenditure was incurred on the purchase of a patent right, right to know-how or an SIPR for the purposes of a trade, profession or

business which was about to commence, the expenditure is to be treated under section 16E(3A) or 16EA(10) as if it had been incurred on the first day on which the trade, profession or business is carried on.

## **CONDITIONS FOR DEDUCTION**

40. Paragraphs 41 to 56 below set out the conditions that must be satisfied to support a deduction claim in respect of a patent right, right to know-how or an SIPR.

### *Registration requirement*

#### *Registration systems in place*

41. Since registration systems are in place for patents, plant varieties, designs and trade marks, a patent right or a plant variety right must have been granted while a design or trade mark must have been registered on the date of acquisition with the relevant authorities. For rights to know-how, copyrights, performer's economic rights and protected layout-design (topography) rights, no registration requirement is required.

#### *Registration in Hong Kong or overseas*

42. The scope of the tax deduction covers registrations in Hong Kong as well as overseas registrations. So long as the registration was in force during a part or the whole of the basis period of a year of assessment, deduction of the capital expenditure incurred on purchase of the relevant right, design or mark will be allowed provided that the other prescribed conditions are fulfilled.

#### *Registration of assignment in process*

43. For protection of interests, it is common to submit an application to the relevant registration authorities for registering the related assignment. Recognizing that the registration process in some jurisdictions may take some time to complete, the Commissioner will adopt a liberal approach in considering deduction while the registration process is still going on. In this regard, the relevant right, design or mark undergoing the registration process would also be accepted for claiming deduction. For a patent right, a protected plant variety

right, a registered design and a registered trade mark, deduction would be allowed for the capital expenditure incurred on purchase on the conditions that:

- (a) the relevant right, design or mark has already been registered by the previous owner with the relevant authorities; and
- (b) the application for registering the relevant right, design or mark has been submitted under the name of the person claiming the deduction.

44. To summarize, when applying for deduction of capital expenditure incurred on the purchase, if documentary evidence can be provided to substantiate that all the conditions for deduction have been fulfilled, including that the registration of the relevant right, design or mark has been effective from a date not later than the day of purchase, the deduction will be granted. However, if the application for change of ownership is not eventually approved by the relevant authority, the relevant right, design or mark will not be eligible for deduction. The Assessor will make an assessment or additional assessment, as appropriate to withdraw any deduction previously allowed within the six-year time limit under section 60 of the Ordinance.

#### *Invalidation, revocation and surrender*

45. When the registration of a right, design or mark is subsequently invalidated, revoked or surrendered, the right concerned will not be eligible for the deduction from the date when the invalidation, revocation or surrender becomes effective. The Assessor will, in accordance with section 60 of the Ordinance, make an assessment or additional assessment, as appropriate to withdraw any deduction previously allowed.

#### ***Ownership requirement***

##### *Legal and economic ownership*

46. If a deduction is to be allowed, the person claiming the deduction must possess both the legal and economic ownership (or proprietary interest) in the patent right, right to know-how or SIPR that the person has purchased. Deduction would only be applicable to an outright purchase of a patent right, right to know-how or an SIPR and not to an upfront fee paid for acquiring the

right to use for a specified period. In the generality of cases, where the use of a patent right, right to know-how or an SIPR is granted by the owner as licensor under a licensing arrangement, the person paying a royalty as licensee would not have acquired the legal ownership in the patent right, right to know-how or SIPR concerned.

47. It is put beyond doubt in sections 16E(9) and 16EA(13) of the Ordinance that any expenditure incurred on the acquisition of a “licence” of a patent right, right to know-how or an SIPR is not deductible. In this regard, a “licence” in relation to a patent right, right to know-how or an SIPR is defined in section 16EC(8) as:

- (a) a licence (however described and whether general or limited) authorizing the licensee to use the patent right, right to know-how or SIPR in the manner authorized by the licence; but
- (b) does not include an agreement under which the ownership of the patent right, right to know-how or SIPR will or may be sold to or pass to the licensee unless, in the opinion of the Commissioner, the right to purchase or obtain the ownership of the patent right, right to know-how or SIPR under the agreement would reasonably be expected not to be exercised.

48. On the other hand, expenses relating to the licensing of patent right, right to know-how or SIPR may be deducted upon satisfying the normal deduction rules under sections 16(1) and 17 of the Ordinance (i.e. the expenses are deductible if they are incurred in the production of chargeable profits of the taxpayer and that they are not capital in nature).

#### Example 4

*Company-HK obtained the right to use a patent from the owner by way of a 10-year licence. The consideration included an upfront payment of \$1,000,000 for the grant of the licence and an annual licence fee of \$100,000.*

Since Company-HK did not acquire the legal ownership of the patent, it would not be entitled to a deduction under section 16E or 16EA for whatever payments made under the licensing arrangement.

Nevertheless, the annual licence fee of \$100,000 which was revenue in nature would be deductible under the general deduction provisions of section 16(1). However, the upfront payment in the amount of \$1,000,000 which was capital in nature would be prohibited for deduction under section 17(1)(c).

#### *Partial ownership*

49. A person having partial ownership of a patent right, right to know-how or an SIPR is also eligible to claim for the deduction. Sections 16E(5) and 16EA(12) provide that the purchase and sale of a patent right, right to know-how or an SIPR includes a reference to the purchase and sale of a share or interest in the patent right, right to know-how or SIPR. In the generality of cases, a person's share or interest is proportionate to the capital expenditure incurred by the person. For these cases, the deduction for a person is computed by reference to the amount of capital expenditure incurred by the person in acquiring the patent right, right to know-how or SIPR.

#### Example 5

*Company-HK1 and Company-HK2 acquired a know-how at a consideration of \$100,000. Their respective shares in the know-how were 30% and 70% and their respective capital expenditures incurred were \$30,000 and \$70,000.*

Deductions available to Company-HK1 and Company-HK2 would be \$30,000 and \$70,000 respectively.

50. In the case where a person acquires only a partial share of the patent right, right to know-how or SIPR from the original owner, the person will be granted for the amount of capital expenditure incurred for acquisition of such share in the ownership of the patent right, right to know-how or SIPR. If it happens that a person has incurred expenditure that is excessive when comparing with the person's share or interest in the patent right, right to know-how or SIPR, the Assessor may substitute the true market value for the stated consideration, after considering all the relevant circumstances of the case.

### ***Use requirement***

51. There is no definition of the word “use” under the Ordinance. According to the Shorter Oxford English Dictionary, the word “use” means: “the action of using something; the fact or state of being used; application or conversion to some purpose”. In relation to patent rights, rights to know-how and SIPRs, the word “use” has its ordinary meaning which encompasses their use in the operations, such as manufacturing or trading, or their licensing.

52. The Commissioner will, having regard to the nature and the relevant facts of individual cases, determine whether the patent rights, rights to know-how or SIPRs have been used for production of chargeable profits. If it can be proved to the satisfaction of the Commissioner that concrete steps have been carried out in relation to the use of the patent right, right to know-how or SIPR for production of chargeable profits, the person claiming the deduction will be accepted as having fulfilled the requirement.

### ***Production of chargeable profits requirement***

53. To be eligible for deduction, the patent right, right to know-how or SIPR has to be used in producing the chargeable profits of the person claiming the deduction. Whether the patent, right to know-how or SIPR is used in the production of chargeable profits is a matter of fact and evidence.

#### **Example 6**

*A design registered in 10 jurisdictions was used in 4 jurisdictions and deduction of the expenditure of purchasing the design was claimed in respect of all the jurisdictions on the ground that the purpose of purchasing the design registered in the remaining 6 jurisdictions was to protect the registration of the design in the 4 jurisdictions where it was used.*

The Commissioner would accept the claim only if substantive and reasonable evidence can be provided to prove that the design registered in the remaining 6 jurisdictions had direct and actual impact on the production of profits chargeable to tax in Hong Kong.

## ***Summary of deduction criteria***

### ***Patent rights and rights to know-how***

54. According to section 16E of the Ordinance, where a person has incurred capital expenditure on the purchase of a patent right or right to know-how during the basis period for a year of assessment, subject to the exclusion provisions as discussed in paragraphs 70 to 87 below, deduction of the capital expenditure is allowable to the person for the year of assessment if:

- (a) the registration or grant of the patent right is in force or the right to know-how subsists at the time of the purchase;
- (b) upon the purchase, the person has possessed the legal and economic ownership of the patent right or right to know-how; and
- (c) the patent right or right to know-how is purchased for use in the production of the person's profits chargeable to tax in Hong Kong.

### ***Specified intellectual property rights***

55. According to section 16EA of the Ordinance, where a person has incurred capital expenditure on the purchase of an SIPR during the basis period for a year of assessment (i.e. year of purchase), subject to the exclusion provisions as discussed in paragraphs 70 to 87 below, deduction of the capital expenditure is allowable to the person over 5 consecutive years (or over the remaining period of protection where appropriate, see paragraphs 29 and 30 above) starting from the year of purchase if:

- (a) the copyright subsists, the registration or grant of the registered design, registered trade mark or protected plant variety right is in force, the performer's economic right has not expired, or the protection of the layout-design (topography) has not ceased at the time of purchase and during a part or the whole of the basis period for the year of assessment;
- (b) upon the purchase, the person has possessed the legal and economic ownership of the SIPR;

- (c) at the end of the basis period for the year of assessment, the person has not sold the SIPR; and
- (d) the SIPR has been used in the production of the person's profits chargeable to tax in Hong Kong during a part or the whole of the basis period for the year of assessment.

56. As deduction of the capital expenditure on SIPRs will be spread over 5 years or over the remaining period of protection, each of the years of assessment concerned will be considered separately and the conditions in paragraph 55 above will need to be satisfied for each of the years of assessment concerned.

#### Example 7

*Company-HK purchased a design registered in Jurisdiction-F which was used on products sold in Jurisdiction-F. The profits were chargeable to profits tax in Hong Kong. The registration of the design in Jurisdiction-F was in force and Company-HK did not sell the registered design during the relevant years of assessment.*

Company-HK was eligible to claim deduction for the purchase cost of the registered design incurred in the year of purchase (over 5 years of assessment) because: (a) the design was registered in Jurisdiction-F and was in force where it was used; (b) Company-HK possessed the legal and economic ownership of the registered design and had not sold the registered design at the end of the basis period; and (c) the registered design was used for production of Company-HK's profits chargeable to tax in Hong Kong.

#### Example 8

*Company-HK purchased in the year of assessment 2017/18 from a US company a trade mark at a total consideration of \$1,000,000 which had been registered in Hong Kong and the US. The Hong Kong registered trade mark and US registered trade mark were valued at \$600,000 and \$400,000 respectively. In the year of purchase (i.e. year of assessment 2017/18), sale of the branded goods was made to Hong Kong customers only. In the following year (i.e. year of assessment*

*2018/19), Company-HK set up a branch office in the US for sale of the branded goods to US customers. The profits derived by the US branch office were chargeable to Hong Kong profits tax.*

In the year of assessment 2017/18, since the Hong Kong registered trade mark was wholly used for sale of the branded goods in Hong Kong, the deduction allowable would be \$120,000 (i.e. \$600,000 ÷ 5). No deduction for the US registered trade mark was allowed as it had not been used at all.

In the year of assessment 2018/19, Company-HK used the US registered trade mark for the production of chargeable profits. The deduction allowable in respect of the US registered trade mark would be \$80,000 (i.e. \$400,000 ÷ 5). In respect of the Hong Kong registered trade mark, the deductible amount would be the same as in the year of assessment 2017/18 (i.e. \$120,000). Hence, the total allowable deduction in the year of assessment 2018/19 is \$200,000 (i.e. \$120,000 + \$80,000).

## **DETERMINATION OF TRUE MARKET VALUE**

### ***Commissioner's power to determine the true market value***

57. For the proper computation of the deduction allowable, it is essential that the patent right, right to know-how or SIPR purchased is correctly valued. In the normal course of event, it is the duty of the person who wishes to claim a deduction of the capital expenditure on a patent right, right to know-how or an SIPR to state the same in the person's tax return. The person is not required to attach the valuation report when filing the tax return. However, for the purpose of ascertaining the person's correct tax liability, the Assessor may, as it deems necessary, request the person to provide documentary proof such as valuation report, if available, to substantiate the claim. The Commissioner is empowered under sections 16E(8) and 16EA(9) to determine the "true market price" for any sale or purchase of any patent right, right to know-how or SIPR if he is of the opinion that the consideration does not represent the true market value of that patent right, right to know-how or SIPR at the time of that purchase or sale.

58. As the term “true market value” is not defined in the Ordinance, the Commissioner has to resort to its ordinary meaning. In general, it means the price at which a willing buyer and a willing seller would transact, with each party having access to all relevant information and with neither party under the compulsion to transact. This is in line with the Australian High Court decision in *Spencer v The Commonwealth of Australia* (1907) 5 CLR 418, in which the following principles were recognized:

- (a) existence of a willing but not anxious seller and purchaser;
- (b) existence of a hypothetical market (i.e. if there is no market for the asset being valued, the valuer is to assume a market);
- (c) the parties being fully informed of the advantages and disadvantages associated with the asset being valued; and
- (d) both parties being aware of current market conditions.

### ***Valuation reports***

59. The valuation report provided by the person claiming the deduction is the starting point for the Commissioner to determine the true market value. For warranted cases, the Commissioner may seek separate valuation from independent professional valuers on the “true market value” of the patent right, right to know-how or SIPR concerned.

### ***Purchased or sold together with other assets for a single price***

60. Where a patent right, right to know-how or an SIPR is purchased or sold together with other assets for a single price, the Commissioner under sections 16E(7) and 16EA(8) is empowered to allocate a price for the purchase or sale of the patent right, right to know-how or SIPR having regard to all the circumstances of the transaction.

### ***Rights of objection and appeal***

61. If a person disagrees with the Commissioner’s valuation or allocation of consideration in respect of a patent right, right to know-how or an SIPR, the person can object to the profits tax assessment in which the valuation or

allocation is adjusted. The objection will be processed in accordance with the relevant provisions under Part 11 of the Ordinance.

## **APPORTIONMENT OF RELATED CAPITAL EXPENDITURE**

### ***Partly used in the production of chargeable profits***

62. If a patent right, right to know-how or an SIPR is purchased for use partly in the production of chargeable profits and partly for any other purposes, the deduction allowable under sections 16E(2) and 16EA(7) shall be that part of the capital expenditure that is proportionate to the extent of the use of the patent right, right to know-how or SIPR in the production of the chargeable profits.

#### **Example 9**

*Company-HK purchased a trade mark which was affixed to goods for sale to Hong Kong customers. At the same time, Company-HK granted the use of that trade mark to its fellow subsidiary in Hong Kong for free.*

The trade mark was only partly used by Company-HK in the production of chargeable profits. An adjustment for the non-allowable portion should be made and the appropriate apportionment to be decided would depend on the particular circumstances of the case.

### ***Basis of apportionment***

63. In making an apportionment, the objective is to find a basis which is reasonable and appropriate in the particular circumstances of the case, including the terms of the agreement relating to the patent right, right to know-how or SIPR, the manner and the use to which it is put, the range and scope of the activities both within and outside Hong Kong and whether the whole of the profit is subject to tax in Hong Kong. It is not possible to lay down any hard and fast rule and it will be for the person claiming the deduction to justify his claim and the basis of apportionment adopted.

## **SUBSEQUENT DISPOSAL**

### ***Deemed trading receipts from subsequent sale***

64. Section 16E(3) of the Ordinance provides that where a patent right or right to know-how in respect of which a deduction has been allowed is sold, the relevant proceeds of sale, not otherwise chargeable to profits tax and not exceeding the amount of deduction previously allowed, will be treated as a trading receipt arising in or derived from Hong Kong.

65. Section 16EB(2) provides that where an SIPR in respect of which a deduction has been allowed is sold:

- (a) if the unallowed amount of the SIPR exceeds the relevant proceeds of sale, the excess will be deducted for the year of assessment in the basis period for which the sale occurs; or
- (b) if the relevant proceeds of sale exceed the unallowed amount of the SIPR, or if there is not an unallowed amount, the excess or the relevant proceeds of sale, as the case may be, not otherwise chargeable to profits tax and not exceeding the amount of deduction previously allowed, will be treated as a trading receipt arising in or derived from Hong Kong.

66. The deemed trading receipt mentioned in paragraphs 64 and 65(b) will be treated as accruing at the time of the sale. If the sale occurs on or after the date on which the business is permanently discontinued, the deemed trading receipt will be treated as accruing immediately before the discontinuance according to sections 16E(3) and 16EB(2).

### ***Relevant proceeds of sale***

67. The term “relevant proceeds of sale”, in relation to any patent right, right to know-how or SIPR in respect of which a deduction has been allowed, is defined in section 16E(4) or 16EB(3) to mean:

- (a) if the patent right, right to know-how or SIPR is used wholly in the production of chargeable profits, the proceeds of sale of the patent right, right to know-how or SIPR; or

- (b) if the patent right, right to know-how or SIPR is used partly in the production of chargeable profits, such part of the proceeds of sale of the patent right, right to know-how or SIPR as is proportionate to the extent to which the deduction has been allowed.

68. Where only part of the cost of such patent right, right to know-how or SIPR has been allowed, only that part of the proceeds as is attributable to the relevant cost of the patent right, right to know-how or SIPR will be assessed as a trading receipt. The basis of apportionment of the sale price will depend on the facts of each case.

#### Example 10

*Company-HK purchased a patent at a cost of \$500,000 during the basis period for the year of assessment 2017/18. The patent was used partly in the production of chargeable profits and the allowable proportion was 50%. Company-HK subsequently sold the patent for \$200,000 during the basis period for the year of assessment 2018/19.*

Patent cost of \$250,000 (i.e.  $\$500,000 \times 50\%$ ) would be allowed for deduction for the year of assessment 2017/18. Since the relevant proceeds of sale in the amount of \$100,000 (i.e.  $\$200,000 \times 50\%$ ) did not exceed the deduction previously allowed (i.e. \$250,000), such proceeds would be deemed as a trading receipt for the year of assessment 2018/19.

#### ***Unallowed amount***

69. The term “unallowed amount”, in relation to an SIPR in respect of which a deduction has been allowed and which is subsequently sold, is defined in section 16EB(3) to mean:

- (a) if the SIPR is used wholly in the production of chargeable profits, the amount of specified capital expenditure incurred in relation to the SIPR that is still unallowed as at the time of the sale; or
- (b) if the SIPR is used partly in the production of chargeable profits,

such part of the amount referred to in sub-paragraph (a) above as is proportionate to the extent to which the deduction has been allowed.

### Example 11

*Company-HK purchased a registered trade mark for \$2,000,000 during the basis period for the year of assessment 2016/17. The registered trade mark was used partly in the production of chargeable profits and the allowable proportion was 50% and 60% for the years of assessment 2016/17 and 2017/18 respectively. During the basis period for the year of assessment 2018/19, Company-HK sold the registered trade mark for \$3,000,000.*

Purchase cost of \$2,000,000 would be allowed for deduction and spread over in equal amounts of \$400,000 (i.e.  $\$2,000,000 \div 5$ ) for five consecutive years of assessment starting from 2016/17 and up to 2020/21.

### Years of assessment 2016/17 and 2017/18

Allowable deduction was proportionate to the extent of use of the registered trade mark in the production of chargeable profits:

<u>Year of assessment</u>	<u>Purchase cost to be spread over the 5-year deduction period</u>	<u>Percentage of use</u>	<u>Allowable deduction</u>
	[1]	[2]	[3] = [1] × [2]
2016/17	\$400,000	50%	\$200,000
2017/18	<u>\$400,000</u>	<u>60%</u>	<u>\$240,000</u>
Total	<u>\$800,000</u>	<u>55%</u>	<u>\$440,000</u>

The total allowable deduction for the first two years was \$440,000. The extent to which deduction was allowed for the first two years was 55% (i.e.  $\$440,000 \div \$800,000$ ).

### Year of assessment 2018/19

Since 55% of the registered trade mark was used in the production of chargeable profits, 55% of the sale proceeds of \$3,000,000 would be taken as the relevant proceeds of sale. Similarly, 55% of the purchase cost still unallowed (i.e. \$2,000,000 – \$800,000) would be taken as the unallowed amount.

	\$
Relevant proceeds of sale (\$3,000,000 × 55%)	1,650,000
Unallowed amount (\$2,000,000 – \$800,000) × 55%	<u>(660,000)</u>
Excess amount	<u>990,000</u>
Deemed trading receipt restricted to the amount previously allowed per section 16EB(2)(b)	<u>440,000</u>

As the relevant proceeds of sale (i.e. \$1,650,000) exceeded the unallowed amount (i.e. \$660,000), the excess, to the extent that did not exceed the amount of deduction previously allowed (i.e. \$440,000), would be treated as Company-HK's trading receipts accruing in the year of assessment 2018/19.

### Example 12

*The facts are the same as Example 11 except that the trade mark was sold for \$1,000,000.*

### Year of assessment 2018/19

The unallowed amount was \$660,000 and the amount of relevant proceeds of sale was \$550,000 (i.e. \$1,000,000 × 55%).

	\$
Relevant proceeds of sale (\$1,000,000 × 55%)	550,000
Unallowed amount (\$2,000,000 – \$800,000) × 55%	<u>(660,000)</u>
Allowable deduction per section 16EB(2)(a)	<u>110,000</u>

As the unallowed amount (i.e. \$660,000) was greater than the relevant proceeds of sale (i.e. \$550,000), the excess of \$110,000 would be deductible for the year of assessment 2018/19.

## **DEDUCTION NOT ALLOWED UNDER CERTAIN CIRCUMSTANCES**

70. Section 16EC provides for non-deduction of expenditure in various circumstances and applies to patent rights, rights to any know-how as well as SIPRs.

### ***Purchase with early termination of licence (transitional provision)***

71. Section 16EC(1) provides that no deduction is allowable in respect of any SIPR purchased by a person if:

- (a) at any time before the respective commencement date (i.e. 16 December 2011 (in relation to a copyright, registered design or registered trade mark); or 29 June 2018 (in relation to a performer's economic right, protected layout-design (topography) right or protected plant variety right)), the SIPR had been used by the person under a licence the expiry date of which fell on or after the respective commencement date;
- (b) the licence was terminated before that expiry date; and
- (c) the Commissioner is of the opinion that, having regard to the early termination of the licence, the consideration for the purchase is not reasonable consideration in the circumstances of the case.

72. This provision aims to prevent the licensor and the licensee of an SIPR from abusing the deduction by turning the licensing arrangement into a sale and purchase arrangement with an unreasonably “low” purchase consideration which may be bundled with an option to buy back the SIPR on a later day. By doing so, the licensor would enjoy the benefits of turning the chargeable profits (i.e. the original royalties) into non-taxable capital receipts, whereas the licensee enjoys the benefit of accelerated deduction (5-year straight-line deduction vis-a-vis annual deduction over the whole licensing period).

73. The Commissioner takes the view that termination of the licence of an SIPR for the purposes of section 16EC(1) includes termination by an implied agreement between the parties or by operation of law. Nevertheless, this anti-avoidance measure would not be applicable to a genuine transaction where the

purchase price of an SIPR is, in the opinion of the Commissioner, a reasonable consideration for acquiring the proprietary interest of the SIPR. Factors influencing the Commissioner's decision include:

- (a) reasons for entering into such a transaction between the licensee and the licensor;
- (b) the terms and conditions agreed between the parties concerned;
- (c) the basis of computation for the purchase price of the SIPR; and
- (d) whether there is an option for the original owner to buy back the SIPR.

74. Section 16EC(1) is a transitional measure. It would not be applicable to a person who became a licensee of an SIPR on or after the respective commencement date (i.e. 16 December 2011 or 29 June 2018, as the case may be) and purchased the same SIPR before the expiry date of the relevant licence. At the time when the person entered into the licensing arrangement, the person already had the option to enjoy the deduction if the person chose to purchase the proprietary interest of the SIPR. Hence, the Commissioner would normally regard that the person did not have a strong motive to turn the licensing arrangement into a sale and purchase arrangement for tax purposes before the expiry date of the relevant licence.

#### ***Purchase from associates***

75. By virtue of section 16EC(2), no deduction is allowable if the patent right, right to know-how or SIPR is purchased wholly or partly from an associate, irrespective of whether or not the price is at an arm's-length. The meaning of "associate" is widely defined under section 16EC(8) to cover natural persons, partners in a partnership, or corporations under common control and trusts.

76. In the case of a trust, the purchase or sale of a patent right, right to know-how or an SIPR by the trustee of the trust estate or a corporation controlled by the trustee would be regarded under section 16EC(3) as the purchase or sale, as the case may be, by each of the trustee, the corporation and the beneficiary under the trust.

### ***Sale and license back arrangement***

77. Under section 16EC(4)(a), deduction would not be allowed in respect of any patent right, right to know-how or SIPR purchased under a sale and license back arrangement. The denial of deduction is intended to prevent an overall tax benefit being obtained through this kind of tax avoidance schemes.

78. In general, section 16EC(4)(a) denies deduction for the capital expenditure incurred on the purchase of a patent right, right to know-how or an SIPR by a person (i.e. the licensor or owner) if:

- (a) at any time when the patent right, right to know-how or SIPR is owned by the person, another person (i.e. the licensee) holds rights as a licensee under a licence (see definition in paragraph 47) of the patent right, right to know-how or SIPR; and
- (b) the patent right, right to know-how or SIPR was, before it was purchased by the person, owned and used by the “end-user” who is either:
  - (i) the licensee, whether alone or with others; or
  - (ii) an “associate” of the licensee.

For this purpose, the term “associate” has been defined widely in section 16EC(8) in order to prevent circumvention of the provisions by the interposition of third parties.

79. Section 16EC(5) is a carve-out provision excluding genuine commercial financing arrangements from the anti-avoidance provisions. This exception applies in the situation where:

- (a) the patent right, right to know-how or SIPR was purchased by the person from the end-user at a price not more than the purchase price paid by the end-user to the supplier as required by section 16EC(5)(a);
- (b) the patent right, right to know-how or SIPR was purchased by the end-user from the supplier on or after the respective

commencement date (i.e. 16 December 2011 (in relation to a patent right, right to know-know, copyright, registered design or registered trade mark); or 29 June 2018 (in relation to a performer's economic right, protected layout-design (topography) right or protected plant variety right)) as required by section 16EC(5)(b); and

- (c) no deduction in respect of the purchase cost of the patent right, right to know-how or SIPR has been made to the end-user before the purchase of the patent right, right to know-how or SIPR by the taxpayer as required by section 16EC(5)(c).

This exception is added so that a person, who has a need to purchase a new patent right, right to know-how or SIPR, can still obtain finance through sale and license back arrangements, without being hindered by the anti-avoidance provisions. The carve-out provision is not applicable to any patent right, right to know-how or SIPR purchased by the end-user before the respective commencement date.

#### Example 13

*On 1 June 2017, Company-HK1 purchased a performer's economic right and immediately put it into business use. On 1 July 2018, Company-HK1 sold the performer's economic right to Company-HK2 which in turn licensed it back to Company-HK1 for royalties.*

Company-HK2 would be denied deduction in respect of the purchase of the performer's economic right under section 16EC(4)(a) because the performer's economic right was, before it was purchased by Company-HK2, owned and used by Company-HK1. The exception in section 16EC(5) did not apply because Company-HK1 purchased the performer's economic right before 29 June 2018 and the condition under section 16EC(5)(b) was not fulfilled.

#### Example 14

*On 1 June 2017, Company-HK1 purchased a copyright at a cost of \$1,000,000 for its business use. Shortly after the purchase and without claiming any deduction in respect of the purchase cost of the copyright, Company-HK1 sold the copyright to Company-HK2 at the*

*same price and in turn, Company-HK2 licensed the copyright back to Company-HK1 for an annual fee of \$110,000 for a period of 10 years. Under the licensing agreement, Company-HK1 had no right to purchase or obtain ownership of the copyright.*

The conditions in section 16EC(5) would be satisfied and Company-HK2 would not be denied deduction. Company-HK1 in effect made use of the sale and license back arrangement to obtain the right to use the copyright without initial capital outlay. Company-HK2, the licensor, had in effect committed capital into the copyright, incurring genuine commercial risk. The whole arrangement was a normal commercial transaction.

80. Since entitlement to deduction is automatic upon purchase of the patent right, right to know-how or SIPR, in order for the exception in paragraph 79 above to apply, it will be necessary for the end-user to submit a disclaimer to the Commissioner in writing within 3 months from the date on which the patent right, right to know-how or SIPR was acquired, or within such further period as the Commissioner may permit. Generally, the Commissioner will not entertain requests for an extension of the 3-month disclaimer period. A notice of disclaimer should be accompanied by the following information:

- (a) a description of the patent right, right to know-how or SIPR;
- (b) the name and address of the seller (or preceding seller);
- (c) the date of purchase from and price paid to the seller (or preceding seller);
- (d) the date of sale to and price paid by the licensor; and
- (e) the name and address of the licensor.

The above information must be supported by copies of the purchase and sale agreements or invoices and the licence agreements.

81. After submitting a notice of disclaimer, the end-user might decide to retain the right to claim deduction and seek to cancel the sale and license back arrangement. As a concession, the Commissioner is prepared to allow the

withdrawal of a disclaimer, provided that the relevant assessment has not yet become final and conclusive.

***Used wholly or principally outside Hong Kong by other persons***

82. Section 16EC(4)(b) stipulates that no deduction is allowable under section 16E or 16EA in respect of any patent right, right to know-how or SIPR purchased by a person (i.e. the licensor or owner) if:

- (a) at any time when the patent right, right to know-how or SIPR is owned by the person, another person holds rights as a licensee under a licence of the patent right, right to know-how or SIPR; and
- (b) the patent right, right to know-how or SIPR is, while the licence is in force, used wholly or principally outside Hong Kong by a person other than the person who owns the patent right, right to know-how or SIPR.

83. Following similar principles behind section 39E of the Ordinance, the purpose of section 16EC(4)(b) is to deny tax deduction in respect of a patent right, right to know-how or an SIPR which is used outside Hong Kong by a person other than the owner for the production of profits not chargeable to tax in Hong Kong.

**Example 15**

*Company-HK purchased an SIPR and allowed its overseas sub-contractor to use the SIPR outside Hong Kong for the sub-contractor's production activities at no cost.*

Under section 16EC(4)(b), Company-HK would be denied deduction of the capital expenditure incurred on the purchase of the SIPR. The profits derived from the overseas production activities were profits of the sub-contractor, not profits of Company-HK. Based on the territorial source principle, the profits derived by the sub-contractor from the overseas production activities were sourced outside Hong Kong and would not be chargeable to Hong Kong profits tax. In accordance with the tax symmetry principle, Company-HK should not

be granted deduction in respect of the SIPR since the royalty income, if any, could be sourced outside Hong Kong.

84. Taking into consideration of the peculiar nature of IPRs, the territorial registration system and protection of the rights and the wide scope in which the rights can be used, the Commissioner is prepared to adopt a pragmatic approach in applying the provisions. The application of section 16EC(4)(b) is illustrated by the following examples.

#### Example 16

*Company-HK, which was carrying on a trading business in Hong Kong, purchased a trade mark registered in Hong Kong at a cost of \$1,000,000 during the basis period for the year of assessment 2018/19. The trade mark was not registered in any places other than Hong Kong. Company-HK contracted Company-F, a manufacturer located in Jurisdiction-F, to produce goods bearing the Hong Kong registered trade mark. The finished goods were sold by Company-HK to customers in Hong Kong and the profits derived were chargeable to tax in Hong Kong.*

Company-HK only purchased the Hong Kong registered trade mark and did not acquire any right to use the trade mark in places other than Hong Kong. When manufacturing the goods in Jurisdiction-F, what Company-F used was an unregistered trade mark in Jurisdiction-F, not the trade mark registered in Hong Kong. In the circumstances, section 16EC(4)(b) would not be applicable. Since the profits derived by Company-HK from selling the finished goods were chargeable to tax in Hong Kong and provided that other deduction requirements were satisfied, Company-HK was entitled to deduct one-fifth of the purchase cost of the Hong Kong registered trade mark (i.e. \$200,000) for the year of assessment 2018/19.

#### Example 17

*Company-HK, which was carrying on a trading business in Hong Kong, purchased a trade mark registered in Hong Kong at a cost of \$2,000,000 during the basis period for the year of assessment 2018/19. The trade mark was not registered in places other than Hong Kong.*

*Company-HK subsequently registered the same trade mark in Jurisdiction-F and contracted Company-F, a manufacturer in Jurisdiction-F, to produce in Jurisdiction-F goods bearing the trade mark. The goods produced by Company-F were sold in Hong Kong by Company-HK and the profits derived were chargeable to tax in Hong Kong.*

Company-HK only purchased the Hong Kong registered trade mark but not the trade mark registered in Jurisdiction-F. It became the registered owner of the trade mark in Jurisdiction-F because it subsequently registered the trade mark in Jurisdiction-F. The trade mark used by Company-F in the production of goods in Jurisdiction-F was the one registered in Jurisdiction-F by Company-HK and not the Hong Kong registered trade mark purchased by Company-HK. As such, section 16EC(4)(b) would not be applicable. Since the profits derived by Company-HK from selling the finished goods were chargeable to tax in Hong Kong and provided that the other deduction requirements were satisfied, Company-HK was entitled to deduct one-fifth of the purchase cost of the Hong Kong registered trade mark (i.e. \$400,000) for the year of assessment 2018/19.

#### Example 18

*During the basis period for the year of assessment 2018/19, Company-HK, which was carrying on a trading business in Hong Kong, purchased a trade mark registered both in Hong Kong and Jurisdiction-F at a cost of \$3,000,000. The Hong Kong registered trade mark and the Jurisdiction-F registered trade mark were each valued at \$1,500,000. Company-HK contracted Company-F, a contract manufacturer located in Jurisdiction-F, to produce goods bearing the trade mark. All of the finished goods were sold by Company-HK to customers in Hong Kong and the profits derived were chargeable to tax in Hong Kong.*

Insofar as the trade mark registered in Hong Kong was concerned, it was used by Company-HK itself for selling the finished goods to produce profits chargeable to tax in Hong Kong. Therefore, section 16EC(4)(b) would not be applicable. For the year of assessment 2018/19, Company-HK was entitled to deduct one-fifth of the

purchase cost of the Hong Kong registered trade mark (i.e. \$300,000).

As for the Jurisdiction-F registered trade mark, it was used by Company-F for production of goods in Jurisdiction-F. As such, section 16EC(4)(b) would be applicable and the purchase price of \$1,500,000 for the Jurisdiction-F registered trade mark would not be deductible.

### Example 19

*Facts are the same as Example 18. However, the finished goods were sold by Company-HK to customers in Hong Kong and the US. The profits so derived were chargeable to tax in Hong Kong.*

Insofar as the trade mark registered in Hong Kong was concerned, it was used by Company-HK itself for selling the finished goods to produce profits chargeable to tax in Hong Kong. In addition, Company-HK when selling the goods in the US market was not using the trade mark registered in Hong Kong. As such, section 16EC(4)(b) would not be applicable. For the year of assessment 2018/19, Company-HK was entitled to deduct one-fifth of the purchase cost of the Hong Kong registered trade mark (i.e. \$300,000).

As for the Jurisdiction-F registered trade mark, it was used by Company-F for production of goods in Jurisdiction-F. As such, section 16EC(4)(b) would be applicable and the purchase price of \$1,500,000 for the Jurisdiction-F registered trade mark was not deductible.

### Example 20

*Facts are the same as Example 18 except Company-F manufactured 1,000,000 pieces of goods during the basis period for the year of assessment 2018/19. However, the goods were sold by Company-HK to customers in Hong Kong, the US and Jurisdiction-F in the respective quantities of 200,000, 200,000 and 600,000. The profits so derived were all chargeable to tax in Hong Kong.*

Insofar as the trade mark registered in Hong Kong was concerned, it was used by Company-HK itself for selling the finished goods to produce profits chargeable to tax in Hong Kong. In addition,

Company-HK when selling the goods in the US market and the Jurisdiction-F market was not using the trade mark registered in Hong Kong. As such, section 16EC(4)(b) would not be applicable. For the year of assessment 2018/19, Company-HK was entitled to deduct one-fifth of the purchase cost of the Hong Kong registered trade mark (i.e. \$300,000).

As for the Jurisdiction-F registered trade mark, it was partly used by Company-F for production of goods in Jurisdiction-F and partly used by Company-HK for selling some of the finished goods in Jurisdiction-F. In the circumstances, section 16EC(4)(b) would be applicable to the part of the Jurisdiction-F registered trade mark that was used by Company-F in manufacturing activities in Jurisdiction-F. Nevertheless, Company-HK was still entitled to deduct part of purchase price of the Jurisdiction-F registered trade mark which was used by itself to sell the finished goods in Jurisdiction-F, producing profits chargeable to tax in Hong Kong.

In calculating the deductible amount, one possible method of apportionment is the ratio of deductible activities (i.e. sales) to total activities (i.e. sales and manufacturing) in connection with the use of the trade mark. The amount of deduction for the Jurisdiction-F registered trade mark would be calculated as follows:

$$\begin{aligned} & \text{Purchase price of} && \text{No. of units sold in Jurisdiction-F} \\ & \text{the Jurisdiction-F} & \div & 5 \times \frac{\text{No. of units manufactured in}}{\text{Jurisdiction-F and no. of units sold}} \\ & \text{registered} && \text{in Jurisdiction-F} \\ & \text{trade mark} && \\ \\ & = \$1,500,000 \div 5 \times \frac{600,000}{1,600,000 \text{ (i.e. } 1,000,000 + 600,000\text{)}} \\ \\ & = \underline{\$112,500} \end{aligned}$$

### ***Leveraged licensing arrangement***

85. A leveraged licensing arrangement is typically one in which a partnership of companies acquires a patent right, right to know-how or an SIPR which the partnership licenses for a fixed term, say 10 years, to a licensee and where, by reason of the “leverage” obtained from the borrowing of a substantial non-recourse loan, the members of the partnership are effectively at risk for no more than a relatively small part of the funds used to acquire the patent right, right to know-how or SIPR. The lenders’ security for the substantial amounts lent to acquire the patent right, right to know-how or SIPR is limited to the patent right, right to know-how or SIPR itself and/or by way of a charge over the licence and the related licence fees or royalties.

86. So far as it relates to leveraged licensing arrangements, section 16EC(4)(c) denies deduction for the capital expenditure incurred on the purchase of a patent right, right to know-how or an SIPR by a taxpayer (i.e. the licensor or owner) if:

- (a) at any time when the patent right, right to know-how or SIPR is owned by the taxpayer, another person holds rights as a licensee under a licence of the patent right, right to know-how or SIPR; and
- (b) the whole or a predominant part of the consideration for the purchase of the patent right, right to know-how or SIPR was financed directly or indirectly by a non-recourse debt.

87. The term “non-recourse debt” is defined extensively in section 16EC(8) but in broad terms means, as mentioned above, a method of financing where the borrower has no absolute liability in respect of the borrowing and in the event of default in repayment, the rights of the lender are restricted to the patent right, right to know-how or SIPR itself or the income generated by it.