

## **Inland Revenue (Amendment) Ordinance 2004 – Extending the Scope of Charge of Royalty Income**

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It has been generally established that royalty income derived from the use of intellectual property (“IP”) such as patent, design, trademark, copyright, secret process or formula, or other property of similar nature is subject to profits tax when it is of a Hong Kong source and is received by a person carrying on a trade, profession or business in Hong Kong. The Inland Revenue Department (“IRD”) considers the source of royalty income of an IP is determined by the location where the IP is registered. It follows that royalty income will be taxable in Hong Kong if the IP is registered in the territory regardless of the place of use. On the other hand, if an overseas IP owner allows a Hong Kong company to use its IP in Hong Kong in return for a fee, the income so earned by the non-resident owner will be deemed as taxable business receipt in Hong Kong under Section 15(1)(b) of the Inland Revenue Ordinance (“IRO”).

The courts decisions in Emerson Radio Corporation case, however, were deviated from the above long-standing assessing practice of the IRD. In this case, the overseas parent company assigned the use of its trademark to its Hong Kong subsidiary in return for a royalty fee. As sales orders increased, the factory of the Hong Kong subsidiary was in over-capacity. Some of the products therefore were shifted to China for production. The taxpayer did not agree with the Board of Review’s decision that such royalty income derived from the use of the trademark in China was chargeable to profits tax in Hong Kong and hence, it appealed to the courts. Interestingly, the judgments made by the Court of First Instance, the Court of Appeal and the Court of Final Appeal were all in favour of the taxpayer. They ruled that the word “use” should be applied to its peculiar meaning under the Trademark Law. There would only be a “use of, or a right to use” of IP in Hong Kong if the goods were manufactured in or sold in the territory. Therefore the royalty paid on goods manufactured by the taxpayer outside Hong Kong was not royalty paid for the “use of an IP in Hong Kong” under Section 15(1)(b) and hence, it was not chargeable to profits tax, even though the taxpayer had claimed tax deduction for the royalty payment.

The decision resulted in a loss of tax revenue of more than HK\$200 million a year. In order to plug the loophole of the existing provisions in the IRO, an amendment to the legislation was proposed and a new deeming provision was introduced seeking to clarify the definition of “use” in the context of the existing provisions in the IRO. The new provision is applicable to sums received by or accrued to a non-resident person *on or after 25 June 2004*. Under the new Section 15(1)(ba), all sums of royalty received by non-residents from Hong Kong companies *for the use of or the right to use an IP outside Hong Kong* will be *deemed as trading receipts if the payer of these royalties has claimed tax deductions in Hong Kong*. The effective withholding tax rate is currently at 5.25% of the gross royalty payment.

Being a deemed agent, the Hong Kong payer is required to withhold the profits tax payable and report to the IRD the royalty payments in the annual Non-resident Profits Tax Return. Hong Kong companies should therefore pay attention to the above tax withholding and reporting requirements after the introduction of the above new provision to the IRO.