

Hong Kong Tax Alert

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Hong Kong to introduce patent box tax incentive

On 1 September 2023, the Commerce and Economic Development Bureau (CEDB) issued a consultation paper on the “Introduction of a Patent Box Tax Incentive in Hong Kong” (the Paper).

The Paper proposes that eligible IP income derived from eligible intellectual property (IP) assets that are patents or patent-like will be taxed at a concessionary tax rate in Hong Kong. The exact concessionary rate to be offered is one of the features of the proposals that views are sought.

The extent of the eligible IP income that will be taxed at the concessionary rate is to be determined by the “nexus approach” as explained in the Action 5: 2015 Final Report of the Base Erosion and Profit Shifting Project released by the Organization of the Economic Co-operation and Development and the Group of Twenty (Action 5 Report).

Subject to the views collected in a one-month consultation period ending on 30 September 2023, the HKSAR Government (the government) will codify the proposals by way of amending the Inland Revenue Ordinance (IRO) by the first half of 2024.

Clients who have any views or thoughts on the proposals can contact their tax executives and we will convey the same to the CEDB in an appropriate manner.

This alert explains details of the proposals contained in the Paper.

Eligible IP assets

Eligible IP assets under the proposals are patents and other IP assets that are functionally equivalent to patents. Specifically, these eligible IP assets are required to be both legally protected and subject to approval and registration processes, where such processes are relevant. Such IP assets include:

- (i) Patent;
- (ii) Copyrighted software; and
- (iii) Plant variety rights.

As a transitional measure, the scope of these eligible IP assets will include applications for patents and plant variety rights made, as well as those patents and plant variety rights granted in or outside Hong Kong for the 24 months after the introduction of the proposed patent box tax incentive.

However, after the 24-month transitional period, it is proposed that eligible IP assets will then only cover those applications and grants made under the local patent system and the plant varieties protection system¹.

The stated purpose for such a requirement is to encourage and promote more local filings such that the relevant inventions or research and development (R&D) outcomes comply with the relevant requirements in Hong Kong.

Eligible IP income

Under the proposals, the following onshore-sourced income derived from the eligible IP assets will be taxed at the concessionary rate:

- (i) Income derived from an eligible IP asset in respect of the exhibition or use of, or a right to exhibit or use (whether in or outside Hong Kong) the asset; or the imparting of, or undertaking to impart, knowledge directly or indirectly connected with the use (whether in or outside Hong Kong) of the asset, i.e., covering most royalties or licensing income;
- (ii) Income arising from the sale of an eligible IP asset (apparently only applies to eligible IP assets that are revenue in nature as onshore income derived from the sale of eligible IP assets that are capital in nature would be non-taxable capital gains in Hong Kong under section 14 of the IRO); and
- (iii) Where the sales price of a product or service includes an amount which is attributable to an eligible IP asset – such portion of the income from those sales as, on a just and reasonable basis, is attributable to the value of the asset (e.g., that ascertained based on the transfer pricing principles and methodologies).

Calculation of the extent of the eligible IP income subject to the concessionary tax rate under the “nexus approach”

Broadly, under the “nexus approach”, the extent of the eligible IP income that will be taxed at the concessionary rate is to be determined by reference to the ratio of qualifying R&D expenditures (QE) that are directly connected to an eligible IP asset to the total related R&D expenditures, including both QE and non-qualifying R&D expenditures (NE).

Specifically, acquisition costs of an IP asset are not considered to be QE and can only be included as NE in the denominator of the ratio. The QE can however be uplifted by 30%, capped at 100% of the total of the QE and NE.

¹ The Paper states that the local filing requirement for the proposed patent box tax incentive will involve the following: (a) the invention of any eligible patent from which the eligible IP income is derived must be included in an application filed under Hong Kong’s original grant patent (OGP), a granted OGP, a short-term patent (STP) application or a granted STP for which a post-grant substantive examination request has been filed. Any STP owner or third party having a legitimate interest in the validity of a STP may request the Patents Registry to carry out substantive examination on the underlying invention. This post-grant mechanism, which was introduced together with the launch of the OGP system in 2019, safeguards the integrity of the STP system while maintaining its overall cost-effectiveness; and (b) the plant variety of any eligible plant variety right must be the subject plant variety of a Hong Kong application for or grant of a plant variety right under the Plant Varieties Protection Ordinance (Cap 490) in respect of such plant variety.

The OGP system provides an alternative but direct filing route for seeking standard patent protection in Hong Kong, which runs in parallel with the existing re-registration system. It allows applicants to seek standard patent protection in Hong Kong directly without having to first file an application with a designated patent office outside Hong Kong as required under the re-registration route, thereby enabling OGP applicants (particularly those in Hong Kong) to secure the first date of patent filings as early as possible.

The table below summarizes what are regarded as QE and NE under the “nexus approach”:

R&D expenditures	QE	NE
Undertaken by the taxpayer themselves inside or outside Hong Kong	✓	
Outsourced by the taxpayer to unrelated parties for R&D activities that take place inside or outside Hong Kong	✓	
Outsourced to Hong Kong resident related parties for R&D activities to take place inside Hong Kong	✓	
Outsourced to Hong Kong resident related parties for R&D activities that take place outside Hong Kong		✓
Acquisition costs of an eligible IP asset		✓

Concessionary tax rate to be decided

While recognizing that the concessionary tax rate offered by most preferential tax regimes of Hong Kong is 8.25%, the Paper also notes some of the more attractive concessionary tax rates offered by the patent box regimes of the following overseas jurisdictions:

- Luxembourg at 4.99%;
- Ireland at 6.25%;
- Israel at 5% to 16%;
- Korea at 4.5% to 18%;
- Singapore at 5% or 10%.

The government welcomes views on the concessionary tax rate to be offered in Hong Kong under the proposals.

Treatment of tax losses and related offsets

The Paper proposes to adopt a mechanism similar to the existing provisions for cross set-off of losses subject to different tax rates under sections 19CAB and 19CAC of the IRO. In other words, a loss incurred in relation to income benefiting from the proposed patent box tax incentive can be allowed to set off against assessable profits subject to a tax rate other than that provided under the proposed regime so long as the amount of the loss allowed is to be adjusted with reference to the tax rate difference.

Record keeping requirements

Under the “nexus approach”, generally speaking taxpayers are required to track the QE and NE of each eligible IP asset on a cumulative basis starting from the beginning of the development of the asset.

To ease the burden of taxpayers tracking and tracing the historical records before the introduction of the patent box tax incentive, taxpayers will, under the proposals, be allowed to apply a transitional method. Under this transitional method, the ratio of QE to the total of the QE and NE are to be calculated on a three-year backward rolling basis for the initial two years, without the need to segregate the relevant R&D expenditures by each of the eligible IP assets involved. Commencing from year three, taxpayers will need to ascertain the QE and NE of each eligible IP asset and then calculate the nexus ratio of each of them on a cumulative basis starting from the year of the introduction of the patent box tax incentive.

Commentary

We welcome the government proposing to introduce a patent box tax incentive for onshore-sourced eligible IP income in Hong Kong.

The provision of the proposed tax incentive, we believe, will be an important policy tool for encouraging the industrial and R&D sectors, creative industries and IP users to engage in more IP creation and exploitation for trading activities to meet their strategic needs of upgrading products and services and moving up the value chain.

In the meantime, clients who have any views or thoughts on the proposals can contact their tax executives and we will convey the same to the CEDB in an appropriate manner.

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