

Hong Kong Tax Alert

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Bill for patent box tax incentive gazetted

The Inland Revenue (Amendment) (Tax Concessions for Intellectual Property Income) Bill 2024 (the Bill) was gazetted on 28 March 2024. The tax measure introduced by the Bill is generally called a patent box tax incentive.

The aim of the proposed tax incentive is to encourage businesses in Hong Kong to engage in more research and development (R&D) activities for the creation of intellectual property (IP) for commercial exploitation.

Main features of the patent box tax incentive

Under the proposal, the concessionary portion of the assessable profits in respect of eligible IP income derived by an eligible person will, on election, be subject to a concessionary tax rate of 5%. The election will be irrevocable once it is made.

The concessionary portion is to be ascertained by applying the R&D fraction to the relevant assessable profits.

Eligible IP income

Eligible IP income includes one or more of the following onshore-sourced items derived from an eligible IP:

- (i) Income derived from an eligible IP in respect of the exhibition or use of, or a right to exhibit or use the IP, or the imparting of, or undertaking to impart, knowledge connected with the use of the IP
- (ii) Income derived from the sale of an eligible IP
- (iii) Embedded IP income - where the price of a sale of a product or service includes an amount that is attributable to an eligible IP, such portion of the income from that sale as, on a just and reasonable basis, is attributable to the value of the eligible IP
- (iv) An amount of insurance, damages or compensation derived in relation to an eligible IP

For the purpose of ascertaining the embedded IP income, the income attributed to an eligible IP is to be calculated in a way that best secures consistency with the requirements and guidance in the Organisation for Economic Co-operation and Development (OECD) rules.

The OECD rules means (a) the commentary on the business profits article as defined by section 50AAC(1) of the Inland Revenue Ordinance; and (b) the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations published by the OECD on 10 January 2022.

There are provisions in the Bill that where the application or grant of an eligible IP is subsequently abandoned, cancelled, declined, lapsed, revoked or withdrawn, the tax concessions previously granted will be withdrawn.

Eligible IP

Eligible IP means any of the following that is generated from an R&D activity:

- (i) an eligible patent
- (ii) an eligible plant variety right
- (iii) a copyright subsisting in software under the Copyright Ordinance (Cap. 528) or under the law of any place outside Hong Kong

Eligible patents and eligible plant variety rights described in items (i) and (ii) above refer to patents and plant variety rights the application or grant of which are filed or made either in Hong Kong or overseas.

However, to encourage and promote more filings under the local patent system (in particular the original grant patent (OGP) system) and local plant varieties protection system, if the eligible IP is a patent or plant variety right filed or granted outside Hong Kong (i.e., a non-Hong Kong patent or a non-Hong Kong plant variety right), the Bill will additionally require that:

- (i) for a non-Hong Kong patent - there must be an application for or a grant of an OGP or a short-term patent (STP) in Hong Kong for the underlying invention of the non-Hong Kong patent. A post-grant substantive examination request must also be filed for a STP; and
- (ii) for a non-Hong Kong plant variety right - there must be an application for or a grant of a plant variety right in Hong Kong for the plant variety to which the non-Hong Kong plant variety right relates.

Appendix I to this alert summarizes the key features of the patent system in Hong Kong (i) under the OGP, referred to as standard patent (O), and the STP; and (ii) the re-registration in Hong Kong of overseas patents referred to as standard patent (R).

As a transitional measure, in order to give sufficient notice to taxpayers, the additional requirement referred to above will not apply if the application for a non-Hong Kong patent or non-Hong Kong plant variety right is filed overseas within the 24-month period after the commencement date of the proposed patent box tax incentive.

Eligible person

Any person who is an owner or a licensee of an eligible IP would likely qualify as “an eligible person”. This would seem to be the case, given that the term “an eligible person” is defined as “a person who is entitled to derive eligible IP income from an eligible IP.”

However, such a person must have incurred eligible R&D expenditures for developing the eligible IP, if they are to benefit from the proposed patent box tax incentive. This would be the case given that the R&D fraction for ascertaining the concessionary portion of the relevant assessable profits would be 0% if they have not incurred such R&D expenditures.

R&D fraction

The R&D fraction is determined by the below formula and capped at 100%:

$$\frac{\text{Eligible R\&D expenditure (EE) x 130\%}}{\text{EE + non-eligible expenditure (NE)}}$$

The following expenditures are specifically excluded from being EE and NE:

- (i) Interest payments
- (ii) Payments for any land or building

The table below summarizes what will be regarded as EE and NE:

R&D expenditures incurred in respect of an eligible IP	EE	NE
R&D activities 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		✓

Calculation of R&D fraction on a combined basis in certain situations

There are specific provisions in the Bill catering to the situations that an eligible IP is obtained by way of a person (i) amalgamating with the original owner of the eligible IP; or (ii) acquiring all equity interests in the original owner and subsequently acquired or obtained a license for the eligible IP from the original owner.

In these two situations, the EE and NE incurred by the original owner would be deemed as having been incurred by the person succeeding or acquiring or licensing the eligible IP from the original owner. Furthermore, any expenditure incurred by the person for acquiring the eligible IP from the original owner would effectively be ignored as an NE.

Transitional method for calculating the R&D fraction

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

To ease the burden of taxpayers tracking and tracing the historical records before the introduction of the proposed patent box tax incentive, taxpayers will be allowed to apply a transitional method. Under this transitional method, the ratio of EE to the total of the EE and NE is 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 asset involved. Commencing from year three, taxpayers will need to ascertain the EE and NE of each eligible IP asset and then calculate the R&D fraction of each of them on a cumulative basis starting from the year of the introduction of the proposed patent box tax incentive.

Our observation

As compared with the earlier consultation paper, we welcome the Government accepting in the Bill our submission that the scope of eligible IP income should also include “an amount of insurance, damages or compensation derived in relation to an eligible IP”. Such an expansion of the scope is in line with the corresponding regime in the UK.

The concessionary tax rate set at 5% in the Bill, being within the lowest band of the tax rates for such regimes internationally, would also make the proposed patent box tax incentive competitive.

Furthermore, the calculation of the R&D fraction on a combined basis in the two situations referred to above would generally increase the R&D fraction of the subsequent owner of an eligible IP. An example to illustrate the point is contained in the Appendix II to this alert.

Clients who have any questions on the proposed patent box tax incentive including their eligibility to qualify for the same can contact their tax executives.



Appendix I - Key features of the patent system in Hong Kong¹

	Standard patent		STP
	Standard patent (O)	Standard patent (R)	
Protection target	Inventions with longer exploitation/commercialisation terms		Simple inventions with shorter exploitation/commercialisation terms
Maximum protection term (subject to payment of renewal fees)	20 years		Eight years
General patentability requirement	Inventions that are new, involve an inventive step and are industrially applicable		
Limitation of number of claims per patent application	Unlimited		Not more than two independent claims
Pre-application requirement	Nil	Filing a corresponding patent application for the same invention with a designated patent office outside the Hong Kong SAR	Nil
Formality examination of documents filed in support of applications	Mandatory for patent grant		
Substantive examination of patentability of inventions for which patents are applied	Mandatory for patent grant	<ol style="list-style-type: none"> 1. Not required 2. Patent grant is subject to grant of the corresponding patent by the designated patent office 	<ol style="list-style-type: none"> 1. Not required for patent grant 2. The patent owner or a third party may request a post-grant substantive examination to be conducted

¹ The summary was extracted from the website of the Intellectual Property Department:

[Intellectual Property Department - Patent basics \(ipd.gov.hk\)](http://ipd.gov.hk)

Appendix II - Example illustrating the calculation of R&D fraction

- In Year X1, Company A self-developed an eligible IP and incurred EE of \$100.
- At the end Year X1, Company B acquired all the equity interests in Company A and then Company B acquired the eligible IP from Company A at \$100.
- In Year X2, Company B incurred additional EE of \$60 on the eligible IP.

EE and NE incurred on the eligible IP

	Company A
EE	\$100
NE	NIL

	Company B
EE	\$60
NE	\$100*

* Being the acquisition price paid by Company B to Company A for the eligible IP

Under Schedule 17FD contained in the Bill, the EE and NE incurred by Company A will be deemed as having been incurred by Company B and the acquisition price for the eligible IP paid by Company B to Company A will be deducted from the combined NE of Company A and Company B, when calculating the R&D fraction of Company B.

Therefore, on the combined basis, the R&D fraction of Company B of 100% will be calculated as follows:

$$\frac{(100 + 60) \times 130\%}{(100 + 60) + 100 - 100} = 130\% \text{ (capped at 100\%)}$$

However, if there were no such specific provisions for the calculation of the R&D fraction of Company B on a combined basis, the R&D fraction of Company B on its own will be calculated as follows:

$$\frac{60 \times 130\%}{60 + 100} = 48.75\%$$



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