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Hong Kong Tax Alert

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IRD's illustrative examples indicate to benefit from the patent box regime eligible R&D expenditures need to be incurred for creating an eligible intellectual property

- *this is because the 5% concessionary tax rate under the regime only applies to the concessionary portion of the relevant assessable profits derived by an eligible person from an eligible intellectual property (IP). The concessionary portion of the relevant assessable profits for an eligible IP is to be ascertained based on the research and development fraction (R&D fraction) for creating the eligible IP. The R&D fraction is the ratio of the eligible R&D expenditures (EE), subject to an uplift of up to 30%, to the total of the EE and non-eligible R&D expenditure (NE). Taxpayers outsourcing their R&D activities can benefit from the regime where certain conditions are met.*

- *Where different combinations of eligible IPs are embedded in different products sold or services provided, the concessionary portion of the relevant assessable profits in respect of each of the eligible IPs needs to be ascertained on an IP-by-IP rather than on product or service basis.*

- *Where an existing eligible IP is enhanced through further R&D activities, it seems that the enhancements need to be in the form of another new eligible IP before taxpayers can benefit from the regime in respect of income derived from the enhancements.*

This alert discusses the updated illustrative examples recently posted by the Inland Revenue Department (IRD) on its website[1] for the interpretation of various terms employed under the regime, including a key term of what constitutes an "R&D activity" for EE and NE.

Clients who have any questions on whether or how they can benefit from the regime should contact their executives.

[1] The illustrative examples can be retrieved from the link below:
https://www.ird.gov.hk/eng/tax/patentbox_example.htm

Patent Box regime effective from the year of assessment 2023/24

An eligible IP is defined to mean (i) an eligible patent, (ii) an eligible plant variety right or (iii) a copyright subsisting in software.

An eligible person is widely defined to include any person, be they an owner or a licensee of an eligible IP, so long as they are eligible to derive income from the eligible IP.

Eligible IP income is defined to include: (i) licensing income derived from an eligible IP, including compensation where there are infringements and (ii) where an eligible IP is embedded in products sold or services provided, the relevant assessable profits attributable to the eligible IP will need to be ascertained in a just and reasonable manner based on the transfer pricing methodologies.

The term "R&D activity" is defined under section 2 of Schedule 45 to the Inland Revenue Ordinance as follows:

(a) an activity in the fields of natural or applied science to extend knowledge;

(b) a systematic, investigative or experimental activity carried on for the purposes of any feasibility study or in relation to any market, business or management research;

(c) an original and planned investigation carried on with the prospect of gaining new scientific or technical knowledge and understanding; or

(d) the application of research findings or other knowledge to a plan or design for producing or introducing new or substantially improved materials, devices, products, processes, systems or services before they are commercially produced or used.

Examples 1, 2 and 3 – outsourced R&D activities

These three examples illustrate that where a taxpayer outsources their R&D activities to a third party for the creation of an eligible IP, the outsourced R&D activities could be attributable to the taxpayer regardless of where the outsourced entity is located to perform the R&D activities.

However, the service income derived by the outsourced entity for the outsourced R&D activities cannot generally benefit from the regime. This is because the outsourced entity would not own the eligible IP so created. An exception would be where the outsourced entity employs its own existing eligible IP for the outsourced R&D activities.

In the latter case, the outsourced entity's own existing eligible IP would be regarded as being embedded in the services provided by the outsourced entity to the taxpayer. The concessionary portion of the service income attributable to the own existing eligible IP would then need to be ascertained in a just and reasonable manner based on the transfer pricing methodologies.

Example 4 – a licensee being an eligible person

This example involves a pharmaceutical manufacturer company in Hong Kong working in concert with an education institution in Hong Kong to invent a patented medicine for a respiratory disease. The institution retained the ownership of the patent which was an eligible IP and granted to the manufacturer company an exclusive right to commercially use or exploit the patent.

The example states that the manufacturer company, being a licensee having the right to use the patent for deriving income, would be regarded as an eligible person. However, the example does not explicitly indicate whether the manufacturer company would have an R&D fraction to benefit from the regime.

Conceivably if, for example, the manufacturer company and the institution worked in concert in performing different aspects of the R&D activities leading to the creation of the patent, resulting in the manufacturer company incurring EE, then the manufacturer company would have an R&D fraction for the patent.

However, if the terms of the collaboration only involved the manufacturer company sponsoring the institution in monetary terms without active participation in the R&D activities undertaken by the institution, the manufacturer company would not have any EE incurred. This is because such a payment would not be regarded as an EE.

Specifically, Example 25 indicates paying annual licensee fees for an exclusive right to use or exploit a patent would be regarded as an NE, i.e., not an EE.

Example 5, 6, 8 and 9 – what constitutes an "R&D activity"

Examples 5, 6, 8 and 9 illustrate what constitutes an "R&D activity" in the context of (i) an online game and platform, (ii) mobile application and (iii) blockchain protocol.

Illustrative examples	**Business nature and the eligible IPs involved**	**R&D activities**
Example 5	Gaming – hosting online games through a platform. The eligible IPs involved was (i) a new platform and (ii) a new game, on the premises that the new platform and the new game were protected by the copyright law.	(i) New platform – Applying research findings for producing a substantially improved online gaming platform that represented an innovative approach to gaming (limb (d) of the definition above). (ii) New game – Carrying on systematic market research covering the demographics of target audience, popularity of different game genres, performance of competitors and features of competitors' gaming platforms in the market, and applied the research finding to the game design, source code writing and graphic design (limb (b) of the definition above).
Example 6	Mobile application – the eligible IP involved was Company-HK developing a new mobile application as an online shopping platform with a new security technique (version 1.0), on the premises that the new mobile application was protected by the copyright law.	Mobile application (version 1.0) • Engaging an overseas third-party consulting firm to carry on systematic market research covering the trend of the e-commerce sector as well as the strengths and weaknesses of the existing online shopping platforms. In addition, Company-HK conducted a feasibility study for the mobile application (limb (b) of the definition above).
Example 8	The facts are the same as those in Example 6 above. The eligible IP involved was mobile application (version 2.0) which were enhancements to (version 1.0), on the premises that (version 2.0) was protected by the copyright law.	Mobile application (version 2.0) • After releasing the mobile application (version 1.0) to the users, Company-HK carried out further systematic activity for the purposes of feasibility study on the possible enhancements as well as the ways to remedy defects identified on the mobile application (limb (b) of the definition above). • Based on its research findings, Company-HK upgraded the mobile application to a version with new features, security improvements, performance enhancements and bug-fixes (version 2.0). The mobile application (version 2.0) had significantly enhanced the performance of the mobile application (limb (d) of the definition above).
Example 9	Blockchain protocol – the eligible IP involved was a new layer 2 protocol, which was an off-chain system built on top of a blockchain to help extend its capacities for recording transactions in a secured manner with great efficiency and scale, on the premises that the new layer 2 protocol was protected by the copyright law.	New layer 2 protocol • Conducting investigative research on the existing protocols in the market and carried out a feasibility study for applying the blockchain technology (limb (b) of the definition above). • The layer 2 protocol, which was new to the market, was developed based on an existing open-source protocol that was found by overseas non-associated parties (limb (d) of the definition above).

Example 7 – what not constitutes an "R&D activity"

This example is based on the facts stated in Example 6 above. Subsequent to the release of the new mobile application (version 1.0) to the market, Company-HK released an updated version of the mobile application (version 1.1) to fix some minor bugs as well as certain issues reported by the users.

In this case, the IRD considers that de-bugging and making minor improvements, i.e., not substantial enhancements, to an existing mobile application would not fall within the meaning of an "R&D activity" as defined, thus such minor improvements not being able to benefit from the regime. It appears that this would still be the case even if mobile application (version 1.1) may also be protected by the copyright law.

Examples 8 and 10 – apparently only enhancements that lead to the creation of a new eligible IP count

Where an existing eligible IP is enhanced through further R&D activities, these two examples seem to indicate that, in respect of income derived from the enhancements, taxpayers would only be able to benefit from the regime if the enhancements lead to the creation of a new eligible IP.

The facts of Example 8 are stated above. Example 10 involved a Hong Kong company being licensed to use a patented chemical compound for lung cancer detection. The Hong Kong company had rights to further develop the patented chemical compound and commercialize any products so developed. The Hong Kong company's R&D team carried out R&D activities to develop a test kit, which was proved as a new and substantially improved product, based on the patented chemical compound in Hong Kong. The Hong Kong company outsourced clinical trials to a third-party entity resident overseas before the test kit was approved by the Department of Health in Hong Kong. The Hong Kong company also filed its patent application in respect of the test kit to the Intellectual Property Department (IPD) of Hong Kong.

In Example 10, the IRD considers that the work done by the Hong Kong company's R&D team in Hong Kong and the clinical trials performed overseas by the third-party entity would qualify as R&D activities. The test kit would be regarded as an eligible patent as the Hong Kong company made a patent application for it to the IPD.

Example 13 – use of several patents in one single product

This example explains that where several eligible IPs are embedded in products sold or services provided, the portion of sale or service income attributable to the embedded eligible IPs would need to be ascertained in a just and reasonable manner based on the transfer pricing methodologies.

It is of note that unlike the corresponding regimes of certain overseas jurisdictions such as the UK, the regime in Hong Kong only allows such an attribution to be made on an IP-by-IP rather than on product or service basis. This would be the case even where different combinations of eligible IPs are embedded in different products sold or services provided.

In the latter situation, the UK Revenue appears to favor such an attribution to be made on a product-by-product or service-by-service basis (including by product- or service-line basis) allowed in the legislative provisions of the corresponding regime in the UK.

Commentary

We welcome the additional explanation and guidance provided by the IRD in its updated illustrative examples covering the practical application of the regime to different industries or sectors.

Nevertheless, what constitutes an "R&D activity" or substantial improvements to an existing eligible IP may not be obvious in certain situations.

In addition, how the concessionary portion of the relevant assessable profits attributable to an eligible IP embedded in products sold or services provided based on transfer pricing methodologies could be complicated.

Clients who have any questions on whether or how they can benefit from the regime should contact their executives.

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