Hong Kong Tax Alert

2 July 2024
2024 Issue No. 8

The bill for the patent box tax incentive to be enacted into law

On 26 June 2024, the Inland Revenue (Amendment) (Tax Concessions for Intellectual Property Income) Bill 2024[1] (the Bill) passed its third reading in the Legislative Council. The Bill, as passed, is expected to be gazetted on 5 July 2024 and formally becomes law (the new law). The new law, generally referred to as a patent box tax incentive, will apply retrospectively commencing from the year of assessment 2023/24.

This alert summarizes the key features of the patent box tax incentive and the major clarifications made by the government during the legislative process.

[1] The Bill can be retrieved from: https://www.legco.gov.hk/yr2024/english/bills/b202403281.pdf

Main features of the patent box tax incentive

Under the new law, the concessionary portion of the assessable profits in respect of eligible intellectual property (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 research and development (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, where the IP is not regarded as a capital asset

(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) Any amount of insurance, damages or compensation derived in relation to an eligible IP

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where the application or grant of an eligible IP is subsequently abandoned, cancelled, declined, lapsed, revoked or withdrawn, the tax concessions previously granted will be withdrawn.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

(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

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 patent box tax incentive.

R&D fraction

An eligible person must have incurred eligible R&D expenditures for developing an eligible IP if they are to benefit from the 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.

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

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

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		✓

Transitional rule 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 patent box tax incentive, taxpayers will be allowed to apply a transitional rule. Under this transitional rule, the ratio of EE to the total of the EE and NE is to be calculated on a three-year backward average rolling basis for the initial three years, without the need to segregate the relevant R&D expenditures by each of the eligible IP asset involved. Commencing from year four, 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 patent box tax incentive.

Clarifications made by the government when the Bill was being scrutinized by the Bills Committee

Transitional rule

A Committee Stage Amendment (CSA) was made to rectify a drafting deficiency contained in the original form of the Bill that specified that the transitional rule applied from 1 April 2023. Under the CSA, the new law now instead specifies that the transitional rule applies to cover any basis period that falls within the year of assessment commencing from 1 April 2023. As such, the transitional rule could apply as early as from 2 April 2022, i.e., covering a basis period from 2 April 2022 to 1 April 2023 for the year of assessment 2023/24.

Please refer to the example in Appendix I to this alert illustrating how the transitional rule works under the new law.

It should however be noted that the transitional rule only applies where taxpayers do not have detailed records to calculate the R&D fraction based on the EE and NE incurred in respect of each individual eligible IP.

Furthermore, the government has confirmed that taxpayers would not be able to benefit from the transitional rule if they did not incur any EE in respect of any of the eligible IPs during the transitional period e.g., in the case the development of all the eligible IPs had been successfully completed prior to the transitional period. This would still be the case even though the eligible IPs successfully completely developed prior to the transitional period continues to derive eligible IP income in the year of assessment 2023/24 and thereafter. In other words, such eligible IP income could not benefit from the patent box tax incentive given that no EE would have been incurred during the transitional period.

If taxpayers do have the relevant records, they can elect to calculate the R&D fraction for each individual eligible IP based on the EE and NE incurred during a specified period that begins on a date earlier than 1 April 2023.

No product-based approach adopted in Hong Kong for the R&D fraction

The government has confirmed that, unlike many corresponding tax regimes overseas, the streaming of embedded IP income eligible for the concessionary tax rate under the new law will need to be made based on each individual eligible IP rather than based on the product that has incorporated more than one eligible IP. That means, Hong Kong has adopted the IP-by-IP approach and not the product-based approach for the R&D fraction.

For example, where a product has incorporated two patents, Patent A and Patent B, the embedded IP income derived from the sale of the product needs to be streamed into Patent A and Patent B first. The R&D fraction of Patent A and Patent B will then separately apply to determine the concessionary portion of the two separate streams of embedded IP income derived from Patent A and Patent B. However, an appropriate streaming of the embedded IP income derived from the sale of the product into Patent A and Patent B may be challenging in some cases.

In contrast, under a product-based approach, income from the sale of the product would not need to be streamed into Patent A and Patent B first. Instead, the EE and NE of Patent A and Patent B would then be combined to determine the R&D fraction that would apply to calculate the concessionary portion of the embedded IP derived from the sale of the product.

Under the IP-by-IP approach adopted in Hong Kong, where the R&D expenditure covers more than one eligible IP, the expenditure is allowed to be apportioned on a just and reasonable basis (e.g. based on the transfer pricing principles). Whether a particular basis is just and reasonable depends on the facts and circumstances of each case. The government considers that such an approach allows greater flexibility to taxpayers in apportioning expenditures incurred among different IPs and in turn the relevant R&D fraction, as long as the basis is just and reasonable.

Appendix II to this alert provides an example illustrating the difference between the IP-by-IP approach and the product-based approach.

Tax administration

A new form IR1482 - Tax concessions for intellectual property income will be published for taxpayers benefiting from the patent box tax incentive. The form IR1482 is required to be completed and submitted electronically via the eTAX by taxpayers benefitting from the patent box tax incentive.

Commentary

We welcome the enactment of the new law which will further facilitate developing Hong Kong as an international IP trading hub. In addition, the clarifications made by the government in response to submissions made by various professional bodies and organizations to the Bills Committee are equally welcomed. The Inland Revenue Department has also undertaken to provide administrative guidance and illustrative examples on its website and later incorporate the same in a Departmental Interpretation and Practice Notes.

However, many provisions of the new law, particularly the calculation of the embedded IP income derived from the sales of products or services that incorporate one or more eligible IPs based on the transfer pricing principles, are complicated. Clients who wish to explore how they can benefit from the patent box tax incentive can contact their tax executives.

Appendix I - Example illustrating how the transitional rule works under the new law

Year of Assessment	Scenario 1 **(Where no detailed records are kept for the EE and NE incurred in respect of each individual eligible IP, but just the overall expenditures incurred)**	Scenario 2 **(Where detailed records are kept for the EE and NE incurred in respect of each individual eligible IP)**
2021/22	Overall EE incurred, i.e., EE incurred for Patents A and B together: 5,000 Overall EE and NE incurred for Patents A and B together: 10,000	EE incurred for Patent A: 2,200 EE incurred for Patent B: 2,800 EE and NE incurred for Patent A: 4,000 EE and NE incurred for Patent B: 6,000
2022/23	Overall EE incurred for Patents A and B together: 3,000 Overall EE and NE incurred for Patents A and B together: 3,000 (i.e. no NE is incurred)	EE incurred for Patent A: 1,400 EE incurred for Patent B: 1,600 No NE is incurred for Patents A and B
2023/24	Overall EE incurred for Patents A and B together: 2,000 Overall EE and NE incurred for Patents A and B together: 2,000 (i.e. no NE is incurred)	EE incurred for Patent A: 700 EE incurred for Patent B: 1,300 No NE is incurred for Patents A and B
2024/25	**(Detailed records should at least have been kept starting from 2024/25 when the new law was enacted)** EE incurred for Patent A: 400 EE incurred for Patent B: 1,600 EE and NE incurred for Patent A: 2,400 EE and NE incurred for Patent B: 2,600	
2025/26	EE incurred for Patent A: 1,300 EE incurred for Patent B: 700 EE and NE incurred for Patent A: 2,000 EE and NE incurred for Patent B: 1,300	
2026/27	EE incurred for Patent A: 800 EE incurred for Patent B: 300 EE and NE incurred for Patent A: 1,100 EE and NE incurred for Patent B: 700	

The R&D fractions (before applying the 30% uplift) are calculated as follows:-

Year of Assessment	Scenario 1 (Calculated under the transitional rule)	Scenario 2 (Elect to calculate the R&D fraction based on a specified period that begins from 2021/22)
2023/24	10,000/15,000 (i.e., three-year average of the overall EE/overall EE and NE for 2023/24, 2022/23 and 2021/22)	Patent A: 4,300/6,100 Patent B: 5,700/8,900 (i.e., based on the detailed records of the cumulative EE/cumulative EE and NE separately for Patent A and Patent B from 2021/22 up to 2023/24)
2024/25	7,000/10,000 (i.e., three-year average of the overall EE/overall EE and NE for 2024/25, 2023/24 and 2022/23)	Patent A: 4,700/8,500 Patent B: 7,300/11,500 (i.e., based on the detailed records of the cumulative EE/cumulative EE and NE separately for Patent A and Patent B from 2021/22 up to 2024/25)
2025/26	6,000/10,300 (i.e., three-year average of the overall EE/overall EE and NE for 2025/26, 2024/25 and 2023/24)	Patent A: 6,000/10,500 Patent B: 8,000/12,800 ((i.e., based on the detailed records of the cumulative EE/cumulative EE and NE separately for Patent A and Patent B from 2021/22 up to 2025/26)
2026/27	Patent A: 2,500/5,500 Patent B: 2,600/4,600 (i.e., actual EE/actual EE and NE in respect of Patent A and Patent B from 2024/25 when detailed records of the relevant expenditures should have been kept*)	Patent A: 6,800/11,600 Patent B: 8,300/13,500 (i.e., based on the detailed records of the cumulative EE/cumulative EE and NE separately for Patent A and Patent B from 2021/22 up to 2026/27)

* The overall EE and overall NE incurred for the years of assessment 2021/22, 2022/23 and 2023/24 during the transitional period will no longer be relevant in calculating the R&D fraction for the year of assessment 2026/27 and thereafter. That means, starting from the year of assessment 2026/27, the R&D fraction will be based on the cumulative actual EE and NE incurred separately for Patent A and Patent B since 2024/25 when the detailed records of the relevant expenditures should have been kept. The impact of disregarding the overall EE and overall NE incurred during the transitional period in calculating the R&D fraction from the year of assessment 2026/27 onwards would vary among taxpayers, depending on the amounts of EE and NE they incurred before and after the year of assessment 2024/25.

Appendix II

An example illustrating the difference between the IP-by-IP approach and the product-based approach

Company X produces two products, namely Product α and Product β.

Company X incurred the following EE and NE for patented Compounds A and B respectively:-

	Patented Compound A	Patented Compound B
EE	$1,000,000	$0
NE	$0	$500,000
Total expenditures	$1,000,000	$500,000

	Product α	Product β
Eligible embedded IP income derived from the sales (ascertained based on transfer pricing principles)	$10,000	$50,000
Patented Compound(s) used	Patented Compounds A and B	Patented Compound A only

If both the IP-by-IP approach and the product-based approach were allowed, Company X could stream the embedded IP income derived from the sales of products α and β in two ways:

- IP-by-IP approach: with two streams corresponding to patented Compounds A and B. This would mean attributing income from the sales of Product α between two IP sub-streams for the embedded IP income; or
- Product-based approach: with two streams corresponding to Product α (which contains both patented Compounds A and B) and Product β (which contains patented Compound A only).

Under the IP-by-IP approach

Assume 60% of the embedded IP income derived from the sale of the product α is attributable to patented Compound A and 40% to patented Compound B. The amount of the embedded IP income which qualifies for the patent box tax incentive would be calculated as follows:-

	R&D fraction	Product α	Product β
Patented Compound A	($1,000,000 x 1.3)/$1,000,000 = 1*	($10,000 x 60%) x 1 = $6,000	$50,000 x 1 = $50,000
Patented Compound B	($0 x 1.3)/$500,000 = 0	($10,000 X 40%) x 0 = $0	N/A
Embedded IP income qualifying for the concessionary tax rate		$6,000	$50,000

* The R&D fraction is capped at 1.

Under the product-based approach

The amount of the embedded IP income which qualifies for the patent box tax incentive would be calculated as follows:-

	Product α	Product β
R&D fraction	($1,000,000 x 1.3)/$1,500,000 = 0.87	($1,000,000 x 1.3)/$1,000,000 = 1*
Eligible embedded IP income	$10,000 x 0.87 = $8,700	$50,000 x 1 = $50,000

* The R&D fraction is capped at 1.

The new law has not however adopted the product-based approach and therefore taxpayers would need to calculate the concessionary portion of the embedded IP income derived from the sale of Product α based on the IP-by-IP approach shown above.

Hong Kong office

Jasmine Lee, Managing Partner, Hong Kong & Macau
27/F One Taikoo Place, 979 King's Road, Quarry Bay, Hong Kong
Tel: +852 2846 9888 Fax: +852 2868 4432

Non-financial Services

Wilson Cheng
Tax Leader for Hong Kong and Macau
+852 2846 9066
wilson.cheng@hk.ey.com

Business Tax Services/Global Compliance and Reporting

Hong Kong Tax Services

Wilson Cheng
+852 2846 9066
wilson.cheng@hk.ey.com

Tracy Ho
+852 2846 9065
tracy.ho@hk.ey.com

Jennifer Kam
+852 2846 9755
jennifer.kam@hk.ey.com

May Leung
+852 2629 3089
may.leung@hk.ey.com

Ada Ma
+852 2849 9391
ada.ma@hk.ey.com

Ricky Tam
+852 2629 3752
ricky.tam@hk.ey.com

Grace Tang
+852 2846 9889
grace.tang@hk.ey.com

Karina Wong
+852 2849 9175
karina.wong@hk.ey.com

Leo Wong
+852 2849 9165
leo.wong@hk.ey.com

Jacqueline Chow
+852 2629 3122
jacqueline.chow@hk.ey.com

Ryan Dhillon
+852 3752 4703
ryan.dhillon@hk.ey.com

China Tax Services

Ivan Chan
+852 2629 3828
ivan.chan@hk.ey.com

Sam Fan
+852 2849 9278
sam.fan@hk.ey.com

Becky Lai
+852 2629 3188
becky.lai@hk.ey.com

Carol Liu
+852 2629 3788
carol.liu@hk.ey.com

Payroll Operate

Vincent Hu
+852 3752 4885
vincent-wh.hu@hk.ey.com

Accounting Compliance and Reporting

Linda Liu
+86 21 2228 2801
linda-sy.liu@cn.ey.com

Cecilia Feng
+852 2846 9735
cecilia.feng@hk.ey.com

International Tax and Transaction Services

Transfer Pricing Services

Sangeeth Aiyappa
+852 2629 3989
sangeeth.aiyappa@hk.ey.com

Martin Richter
+852 2629 3938
martin.richter@hk.ey.com

Kenny Wei
+852 2629 3941
kenny.wei@hk.ey.com

Transaction Tax Services

Jane Hui
+852 2629 3836
jane.hui@hk.ey.com

Financial Services

Paul Ho
Tax Leader for Hong Kong
+852 2849 9564
paul.ho@hk.ey.com

Business Tax Services/Global Compliance and Reporting

Hong Kong Tax Services

Paul Ho
+852 2849 9564
paul.ho@hk.ey.com

Ming Lam
+852 2849 9265
ming.lam@hk.ey.com

Sunny Liu
+852 2846 9883
sunny.liu@hk.ey.com

Helen Mok
+852 2849 9279
helen.mok@hk.ey.com

Customer Tax Operations and Reporting Services

Paul Ho
+852 2849 9564
paul.ho@hk.ey.com

US Tax Services

Camelia Ho
+852 2849 9150
camelia.ho@hk.ey.com

Michael Stenske
+852 2629 3058
michael.stenske@hk.ey.com

International Tax and Transaction Services

China Tax Services

Cindy Li
+852 2629 3608
cindy.jy.li@hk.ey.com

International Tax Services

Sophie Lindsay
+852 3189 4589
sophie.lindsay@hk.ey.com

Stuart Cioccarelli
+852 2675 2896
stuart.cioccarelli@hk.ey.com

Rohit Narula
+852 2629 3549
rohit.narula@hk.ey.com

Adam Williams
+852 2849 9589
adam-b.williams@hk.ey.com

Maggie To
+852 3752 4779
maggie.to@hk.ey.com

Ruairi Lamb
+852 2846 9070
ruairi.lamb@hk.ey.com

Transfer Pricing Services

Ka Lok Chu
+852 2629 3044
kalok.chu@hk.ey.com

Justin Kyte
+852 2629 3880
justin.kyte@hk.ey.com

Transaction Tax Services

Rohit Narula
+852 2629 3549
rohit.narula@hk.ey.com

People Advisory Services

Mary Chua
+852 2849 9448
mary.chua@hk.ey.com

Christina Li
+852 2629 3664
christina.li@hk.ey.com

Jeff Tang
+852 2515 4168
jeff.tk.tang@hk.ey.com

Winnie Walker
+852 2629 3693
winnie.walker@hk.ey.com

Paul Wen
+852 2629 3876
paul.wen@hk.ey.com

Asia-Pacific Tax Center

Tax Technology and Transformation Services

Agnes Fok
+852 2629 3709
agnes.fok@hk.ey.com

Robert Hardesty
+852 2629 3291
robert.hardesty@hk.ey.com

Albert Lee
+852 2629 3318
albert.lee@hk.ey.com

International Tax and Transaction Services

US Tax Desk

Jeremy Litton
+852 3471 2783
jeremy.litton@hk.ey.com

Operating Model Effectiveness

Edvard Rinck
+852 9736 3038
edvard.rinck@hk.ey.com

Indirect tax

Shubhendu Misra
+852 2232 6578
shubhendu.misra@hk.ey.com

Tax and Finance Operate

Tracey Kuuskoski
+852 2675 2842
tracey.kuuskoski@hk.ey.com

EY | Building a better working world

EY exists to build a better working world, helping to create long-term value for clients, people and society and build trust in the capital markets.

Enabled by data and technology, diverse EY teams in over 150 countries provide trust through assurance and help clients grow, transform and operate.

Working across assurance, consulting, law, strategy, tax and transactions, EY teams ask better questions to find new answers for the complex issues facing our world today.

About EY's Tax services

Your business will only succeed if you build it on a strong foundation and grow it in a sustainable way. At EY, we believe that managing your tax obligations responsibly and proactively can make a critical difference. Our 50,000 talented tax professionals, in more than 150 countries, give you technical knowledge, business experience, consistency and an unwavering commitment to quality service — wherever you are and whatever tax services you need.

ey.com/china

Follow us on WeChat
Scan the QR code and stay up-to-date with the latest EY news.