Consultation on patent box tax incentive launched

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In brief

As foreshadowed in the 2023-24 Budget announced in February 2023, a patent box tax incentive will be introduced to provide tax concessions for profits sourced in Hong Kong and derived from eligible intellectual property (IP) assets generated through research and development (R&D) activities.

On 1 September 2023, the Commerce and Economic Development Bureau published its much-anticipated consultation paper on the proposed patent box regime (the Consultation Paper) as Hong Kong pushes ahead on its goals of becoming an innovation and technology centre and a regional IP trading centre.

The proposed patent box regime closely follows the nexus approach promulgated by the Organisation for Economic Co-operation and Development (OECD), which stipulates that a preferential regime should only apply to a proportion of income based on a 'nexus ratio' calculated by reference to qualifying R&D expenditures as a proportion of overall expenditures incurred to develop the IP asset. The nexus approach is not a new concept and has already been in use for determining the extent to which a foreign-sourced IP income will not be chargeable to profits tax under the refined foreign-sourced income exemption (FSIE) regime.

This news flash summarises the key parameters of the proposed patent box regime and our observations.

In detail

As Hong Kong is a member of the Inclusive Framework on Base Erosion and Profit Shifting (BEPS), the proposed patent box regime is required to apply the nexus approach outlined in the BEPS Action 5 Final Report (the OECD guidelines)[1]. Please refer to the ***Appendix*** for the calculation of a nexus ratio to ascertain the portion of assessable profits that could benefit from the tax concessions under the proposed patent box regime.

Key parameters of the proposed patent box regime

Eligible IP assets

The proposed patent box regime will cover patents and other IP assets that are functionally equivalent to patents if they are both legally protected and subject to similar approval and registration processes, where such processes are relevant, including:

(a) patents;

(b) copyrighted software; and

(c) plant variety rights[2].

The Consultation Paper indicates that eligible IP assets will include patents and plant variety rights granted in or outside Hong Kong, as well as applications for patents and plant variety rights made. However, if the concerned application does not eventually result in a grant, the portion of eligible IP income for which tax concessions were claimed will be subject to the standard profits tax rate accordingly.

Our observations: *As an R&D outcome is often not directly correlated to a product, or a single R&D project, it may be desirable to include a 'family' of eligible IP assets so that two or more eligible IP assets can be grouped into a 'family' where either the expenditure or the income of these IP assets cannot be reasonably identified or separated from each other.*

It should however be noted that the OECD guidelines explicitly state that marketing-related IP assets such as trademarks can never qualify for tax concessions under an IP regime.

Requirements for registered patents and plant variety rights in Hong Kong

While patents and plant variety rights granted in or outside Hong Kong will qualify as eligible IP assets, to encourage and promote more filings under the local patent system and plant varieties protection system, and to ensure that the relevant inventions or R&D outcomes comply with Hong Kong's requirements for patent and plant variety right registrations, the Consultation Paper proposes a requirement that the relevant patent or plant variety right must be included in an application filed under the specified local registration system[3].

Nonetheless, the above requirements will not apply if the date of filing of an eligible IP asset is within a transitional period of 24 months after the commencement date of the patent box regime.

Eligible IP income

Eligible IP income falling within the proposed patent box regime includes:

(a) income (essentially royalties or licence fees) derived from the exhibition/use of, or a right to exhibit/use, or the imparting of / undertaking to impart knowledge directly or indirectly connected with the use of, whether in or outside Hong Kong, an eligible IP asset;

(b) income arising from the sale of an eligible IP asset; and

(c) such portion of the income from the sale of a product or service with an eligible IP asset embedded in them that is attributable to the eligible IP asset, which means that the portion of the income unrelated to the eligible IP asset (e.g. marketing and manufacturing returns) has to be separated on a just and reasonable basis (e.g. based on the transfer pricing principles).

The OECD guidelines establish that IP expenditure allocable to IP income and incurred in the year needs to be deducted from gross IP income earned in the same year prior to the application of the concessionary tax rate.

Our observations: *To provide certainty, the amendment bill implementing the proposed patent box regime may need to clarify whether eligible IP income covers damages for infringement or other compensation from infringement, which are commonly included in the patent box regimes of other jurisdictions.*

Eligible expenditures

Only R&D expenditures that have been incurred by taxpayers to develop an eligible IP asset will be taken into consideration in the calculation of the nexus ratio. As such, acquisitions costs of the IP assets are not considered as eligible expenditures.

The Consultation Paper indicates that the jurisdictional approach will be adopted for determining the scope of eligible expenditures (i.e. the numerator of the nexus ratio). Under this approach, eligible expenditures cover expenditures on R&D activities:

(a) undertaken by the taxpayer in or outside Hong Kong;

(b) outsourced to unrelated parties to take place in or outside Hong Kong; and

(c) outsourced to resident related parties to take place inside Hong Kong.

Our observations: *The OECD guidelines allow jurisdictions that are not member states of the European Union to take either an 'entity' or 'jurisdictional' approach for their nexus ratio calculations, the difference being that a 'jurisdictional' approach permits domestic related party costs to be included in the numerator while the entity approach does not. The adoption of the 'jurisdictional' approach is therefore more favourable and is consistent with the approach adopted in the refined FSIE regime.*

Presumably, the definition of R&D expenditure under the proposed patent box regime will be the same as that used in the refined FSIE regime. It is however unclear whether eligible expenditures would include payments made under a cost-sharing agreement.

Concessionary tax rate

The concessionary tax rate is yet to be determined. The Government is mindful of the need to make the regime competitive and will make reference to the rate of existing preferential regimes in Hong Kong (mostly 8.25%), as well as those of overseas patent box regimes (which could be as low as 4.5%). The Government welcomes views from stakeholders in this regard.

Our observations: *As part of the policy consideration, the Government may also need to review the existing deduction rules in respect of IP-related and R&D costs. In particular, restrictions on deduction for acquisition costs of IP assets acquired from an associate and payments for outsourced R&D activities carried out by persons other than 'R&D institutions' as defined need to be revisited. It is not uncommon for a Hong Kong company operating an R&D function to acquire an IP asset from its overseas group company for further development, as well as to engage other entities to support the R&D activities. Ideally, the proposed patent box regime and the deduction rules should work in concert to attain the intended objective of reducing the profits tax imposed on income from activities related to the development and exploitation of IP assets.*

Treatment of losses and related offsets

A mechanism similar to the existing provisions for cross set-off of losses subject to different tax rates will be adopted. In essence a loss incurred in relation to income benefiting from the proposed patent box regime can be allowed to set off against assessable profits subject to a tax rate other than that provided under the regime (e.g. those taxed at the standard rate of 16.5%), provided that the amount of loss allowed is to be adjusted with reference to the tax rate difference.

Record keeping requirements

One of the essential requirements of the nexus approach is the tracking and tracing of R&D expenditures and income derived from the eligible IP assets. This requires a detailed mechanism of record keeping, entailing for instance information sufficient to establish that the income concerned is eligible IP income and details of the eligible IP assets to which the income relates.

However, as a transitional measure and consistent with the OECD guidelines, a taxpayer will be allowed to apply a ratio where qualifying expenditures and overall expenditures were calculated on a three-year average rolling. The purpose of the transitional measure is to allow sufficient time for taxpayers to adapt to the tracking and tracing requirements while still complying with the general principles of the nexus approach. After the transitional period, the taxpayer will need to change from using the three-year average to using a cumulative ratio.

Implementation timeline

The Consultation Paper does not specify the effective date of the proposed patent box regime. Nevertheless, it is the Government's plan to introduce the relevant amendment bill into the Legislative Council in the first half of 2024.

To assist the Government to formulate the legislative proposal, the Government has invited stakeholders and interested parties to comment on the proposed patent box regime by 30 September 2023.

The takeaway

Recognising that IP commercialisation is important to the continuous development of a knowledge-based economy, many stakeholders (including PwC) has been advocating for the implementation of a patent box regime to stimulate the performance of valuable R&D activities and drive the creation of more patented inventions with market potential in Hong Kong. We are pleased that the Government has taken on board our recommendation and launched a trade consultation to gauge stakeholders' views on the design of the proposed patent box regime.

This new initiative represents an important complement to the enhanced tax deduction regime for qualifying R&D expenditure introduced in 2018[4], which will further incentivise the development and retention of IP assets in Hong Kong, along with the R&D operations that underpin them.

Submissions in response to the Consultation Paper are due by 30 September 2023. Please feel free to contact us if you wish to explore how your company can benefit from the proposed patent box regime or have any views on the Consultation Paper.

Endnotes

1. The BEPS Action 5 Report can be accessed via this link: https://www.oecd-ilibrary.org/taxation/countering-harmful-tax-practices-more-effectively-taking-into-account-transparency-and-substance-action-5-2015-final-report_9789264241190-en;jsessionid=dAuTJTQAW0MJQl9ggWyoBeGZLXOeZyFaLv40r9KV.ip-10-240-5-89

2. Plant variety rights are rights granted to the owners of plant varieties over cultivated plant varieties they have bred or discovered and developed. In Hong Kong, the procedures for applying for such proprietary rights are set out in the Plant Varieties Protection Ordinance (Cap. 490) administered by the Agriculture, Fisheries and Conservation Department.

3. The local registration requirements mandate: (i) 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) system, a granted OGP, a short term patent (STP) application or a granted STP for which a post-grant substantive examination request has been filed; (ii) 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.

4. Under the enhanced tax deduction regime for qualifying R&D expenditures, the deduction is 300% for the first HK$2 million of the aggregate amount of payments made to 'designated local research institutions' for 'qualifying R&D activities' (i.e. outsourced qualifying R&D) and qualifying expenditures incurred by the taxpayer itself (i.e. in-house qualifying R&D), and 200% for the remaining amount. There is no cap on the amount of enhanced tax deductions that can be claimed.

Appendix – Formula for determining the assessable profits qualifying for the tax concessions under the proposed patent box regime

Under the proposed patent box regime, the nexus ratio is determined using the following formula (capped at 100%):

$$\text{Nexus ratio} = \frac{A \times 130\%}{A + B}$$

where

A refers to eligible expenditures that are directly connected to the eligible IP asset. Specifically, A is the sum of the following eligible expenditures incurred by a taxpayer for:

- R&D activities carried out directly by itself in or outside Hong Kong;
- R&D activities outsourced to:
  - unrelated parties to take place in or outside Hong Kong; and
  - resident related parties to take place in Hong Kong.

B refers to other (i.e. non-eligible) expenditures incurred to develop the eligible IP asset. Specifically, B is the sum of the following expenditures incurred by the taxpayer:

- in acquiring the eligible IP asset;
- for outsourced R&D activities carried out by:
  - resident related parties outside Hong Kong; and
  - non-Hong Kong resident related parties.

The nexus ratio is then used to calculate the portion of assessable profits that could benefit from the tax concessions under the proposed patent box regime:

Assessable profits qualifying for tax concessions = (Eligible IP income – Allocable IP expenditure) × Nexus ratio

Let's talk

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