

Bill on patent box tax incentive introduced

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Issue 6

In brief

On 28 March 2024, the Inland Revenue (Amendment) (Tax Concessions for Intellectual Property Income) Bill 2024 (Bill) was gazetted to implement Hong Kong's highly anticipated patent box regime¹, following a one-month consultation conducted in September 2023². This comes on the heels of the various initiatives announced in the 2024/25 Budget intended to make Hong Kong a more attractive location for research and development (R&D) and intellectual property (IP) trading (buying/selling and licensing) activities.

The Bill sets out the proposed design of the patent box regime, which implements a concessionary tax rate of 5% for eligible IP income that is sourced in Hong Kong and derived from an eligible IP developed through R&D activities with effect from the year of assessment 2023/24.

In welcome news, the Government has adopted the following key recommendations raised by PwC in our submission on the proposed regime:

- Setting the concessionary tax rate competitively at 5%; and
- Expanding the scope of eligible IP income to cover insurance, damages or compensation derived in relation to an eligible IP.

While other suggestions made in our submission have not been implemented, the introduction of the patent box represents a positive step towards bolstering Hong Kong's tax competitiveness in the context of R&D commercialisation decisions.

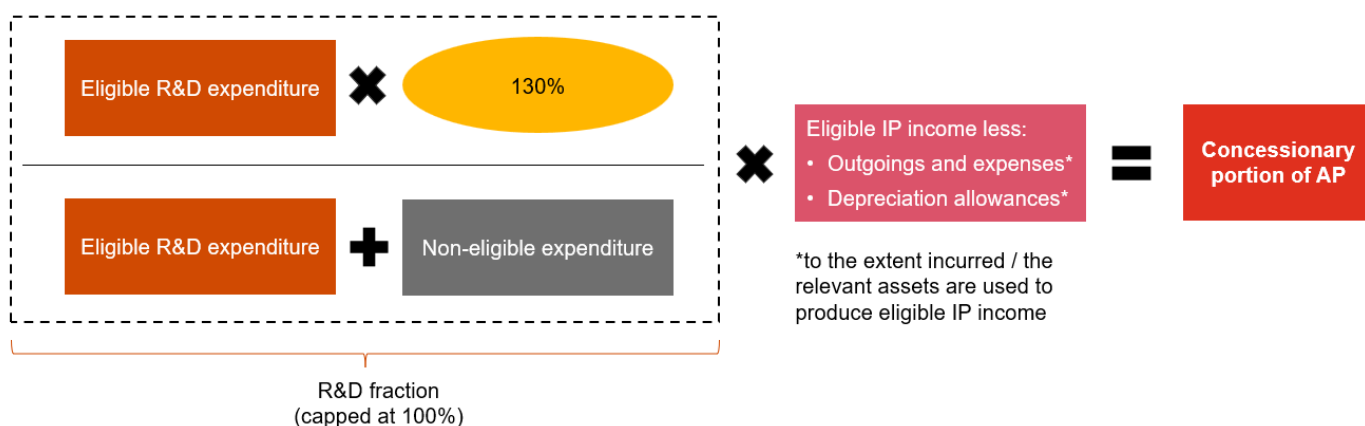
This news flash provides a snapshot of the patent box regime proposed under the Bill and our observations thereon.

In detail

Snapshot of the proposed patent box regime

The patent box regime proposed under the Bill is substantially similar to that outlined in the consultation paper. Subject to any further amendments in its passage through the legislature, the key aspects of the proposed patent box regime are set out below:

- Eligibility for the proposed regime is limited to an 'eligible person' who is entitled to derive eligible IP income from an eligible IP.
- The concessionary tax rate is 5%. The nexus approach³ will apply to determine the portion of assessable profits (AP) of the eligible IP income from an eligible IP that can qualify for the concessional tax treatment, which is calculated by reference to the eligible R&D expenditure (subject to a 30% uplift) as a proportion of the overall expenditure incurred to develop the eligible IP (i.e. the R&D fraction, or commonly known as the 'nexus ratio'). The calculation of the concessionary portion of AP is depicted in the diagram below:



- Eligible IP income refers to one or more of the following:
 - royalties or licence fees derived from an eligible IP;
 - income arising from the sale of an eligible IP (to the extent that such income is revenue as opposed to capital in nature);
 - the portion of income from the sale of a product or service that is attributable to the value of an embedded eligible IP (to be determined based on the Organisation for Economic Co-operation and Development's (OECD) transfer pricing principles); and
 - insurance, damages or compensation derived in relation to an eligible IP.
- Eligible IP only covers patents, copyrighted software and plant variety rights generated from an R&D activity^{4,5}. The regime does not apply to marketing-related IP such as trademarks.
- There is no registration requirement for copyrighted software, while patents and plant variety rights filed after the 24-month grace period after the commencement date of the amendment ordinance must be registered under the designated local registration system⁶.
- The R&D fraction is in line with that in the foreign-sourced income exemption regime. The components of eligible R&D expenditure and non-eligible expenditure are set out below:

Expenditure incurred by the eligible person		Eligible R&D expenditure	Non-eligible expenditure
For an R&D activity related to the eligible IP and carried out by the eligible person		✓	
For an outsourced R&D activity related to the eligible IP and carried out by:			
• non-associated persons		✓	
• Hong Kong resident associated persons	○ in Hong Kong	✓	
	○ outside Hong Kong		✓
• non-Hong Kong resident associated persons			✓
Cost of acquiring IP or licence			✓
Interest payments		N/A	
Payments for land or building (including relevant alteration, addition or extension)			

- In general, an eligible person is required to calculate the R&D fraction based on the cumulative expenditure incurred in connection with the eligible IP on or after 1 April 2023 (or on an earlier date elected by the eligible person). However, an eligible person with insufficient records is allowed to apply a transitional R&D fraction during a three-year transitional period beginning on 1 April 2023. The transitional R&D fraction is calculated based on a three-year average rolling.
- The 5% concessory tax rate will not apply to the concessory portion of AP derived from an eligible IP in the event of abandonment, refusal, cancellation, declination, lapse, unconditional revocation, withdrawal, or the absence of a request for substantive examination (where relevant), of the eligible IP. In such situations, any concessory portions

of AP subject to the concessionary tax rate in prior years will become taxable at the difference between the normal tax rate and the concessionary tax rate in the year of occurrence of the event.

- A loss incurred in relation to income benefiting from the patent box regime can be set off against other AP. However, the amount of loss allowed is to be adjusted with reference to the tax rate difference (e.g. 16.5% corporate tax rate versus 5% concessionary tax rate).
- Eligible persons must make an irrevocable election in writing if they wish to enjoy the concession.
- Eligible persons are obliged to 'track and trace' and provide documentary evidence of the R&D expenditures incurred, income derived from the eligible IP, and activity undertaken to generate the eligible IP.

Our observation: Apparently, eligibility for the proposed regime would be determined on an asset-by-asset basis, and income and expenditure linked to each asset thus need to be identified. Guidance may need to be provided by the Government as to how the regime would apply to interlinked eligible IP, i.e. family of products or services.

Legislative timeline

The Bill will be introduced into the Legislative Council for first reading and second reading on 10 April 2024. It is proposed that the tax concession will have retrospective effect from the year of assessment 2023/24.

The takeaway

Overall, the proposed patent box regime is a commendable initiative that aims to incentivise companies to base their R&D operations and patent commercialisation activities in Hong Kong. Equally welcoming is that the regime has been designed to be as broad as possible while adhering to the constraints of the OECD's nexus approach.

As competition for innovation and technology companies has intensified significantly, it is incumbent upon the Government to implement favourable changes to the related tax rules, thereby enhancing the overall tax landscape in Hong Kong concerning R&D and IP activities. Specifically, we recommend the following changes:

- Allowing unilateral tax credits as a more effective means to relieve taxpayers from double taxation suffered on eligible IP income in both Hong Kong and a territory that has not entered into a comprehensive avoidance of double taxation agreement with Hong Kong;
- Enhancing the existing tax deduction rules on R&D expenditure, acquisition cost of IP and upfront licence fee to better align the ascertainment of the concessionary portion of AP with the nexus approach; and
- Modifying the existing enhanced R&D tax deduction regime to a qualified refundable tax credit scheme to attenuate the downward impact on jurisdictional effective tax rate under the global minimum tax or Hong Kong minimum top-up tax rules, which are expected to take effect in Hong Kong for a fiscal year beginning on or after 1 January 2025.

We remain committed to advocating for these enhancements and welcome any additional suggestions regarding the proposed patent box regime.

Meanwhile, taxpayers wishing to benefit from the patent box regime should evaluate whether they will be able to meet all the relevant conditions, consider their IP registration strategy, assess their level of eligible IP income and eligible IP expenditure, and ensure that relevant records are in place. If you require assistance in understanding the details or evaluating the potential benefits of the proposed regime, please feel free to reach out to us.

Endnotes

1. The Bill and the Legislative Council brief can be accessed via these links:
<https://www.gld.gov.hk/egazette/pdf/20242813/es3202428136.pdf>
https://www.legco.gov.hk/yr2024/english/brief/citbcr061823_20240327-e.pdf
2. The news flash on the consultation paper can be accessed via this link:
<https://www.pwchk.com/en/hk-tax-news/2023q3/hongkongtax-news-sep2023-14.pdf>

3. The nexus approach was adopted by the OECD as a minimum standard under Action 5 of the Base Erosion and Profit Shifting (BEPS) package, and has been applied by the OECD Forum on Harmful Tax Practices to evaluate the harmfulness of preferential tax regimes for IP income put in place by individual jurisdictions. As a member of the Inclusive Framework on BEPS, Hong Kong is obliged to apply the nexus approach.
4. Eligible IP comprises applications for patents (including divisional patent applications) and plant variety rights, as well as those patents and plant variety rights granted in or outside Hong Kong. For copyrighted software, it is defined to mean a copyright subsisting in software under the Copyright Ordinance (Cap. 528) or under the law of any place outside Hong Kong.
5. 'R&D activity' has the meaning given by section 2 of Schedule 45 to the IRO (i.e. the enhanced tax deduction regime for qualifying R&D expenditure) and is defined as follows:
 - (a) an activity in the fields of natural or applied science for the extension of 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 investigations carried on with the prospect of gaining new scientific or technical knowledge; 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.
6. The additional local registration requirements are:
 - (a) for a non-Hong Kong patent: there must be an application for or a grant of an original grant patent 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 an STP. In other words, an application for or a grant of a standard patent under the re-registration system in Hong Kong would not satisfy this local registration requirement;
 - (b) 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 under the Plant Varieties Protection Ordinance (Cap. 490).

Let's talk

For a deeper discussion of how this impacts your business, please contact:

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