



Hong Kong Tax Newsflash

Consultation on patent box tax incentive

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In the 2023-2024 Budget, the Financial Secretary has announced to introduce a patent box tax incentive to provide tax concessions for profits sourced in Hong Kong from qualifying patents generated through research and development (R&D) activities. Last week, the Hong Kong Government has issued a consultation paper on the proposed patent box incentive for Hong Kong sourced intellectual property (IP) income, aiming at encouraging business in Hong Kong to engage in more R&D and IP trading activities.

Proposed patent box tax incentive

In formulating the patent box tax incentive proposal, Hong Kong generally follows the nexus approach adopted by the Organisation for Economic Co-operation and Development (OECD). Specifically, the portion of income from an eligible IP asset that can qualify for preferential tax treatment is based on a “nexus ratio” of the eligible expenditures to the overall expenditures that have been incurred by the taxpayer to develop the IP asset:

$$\begin{array}{l} \text{Income qualifies} \\ \text{for preferential} \\ \text{tax treatment} \end{array} = \frac{\text{Income from an eligible IP asset} \times \text{Eligible expenditures}}{\text{Overall expenditures incurred to develop the IP asset}}$$

Eligible IP assets

Only income derived from an eligible IP asset would be eligible for the patent box tax incentive. Eligible IP assets include:

- Patents – this includes other IP assets that are functionally equivalent to patents if those IP assets are both legally protected and subject to similar approval and registration processes;
- Copyrighted software; and
- Plant variety rights – i.e. rights granted to the owners of plant varieties over cultivated plant varieties they have bred or discovered or developed, under the Plant Varieties Protection Ordinance (Cap.490)

The above include applications made, as well as patents and plant variety rights granted in or outside Hong Kong. The eligible IP assets should be filed under the Hong Kong original grant patent system and plant varieties protection system, and ensure compliance with the Hong Kong local registration requirements.

Eligible expenditures

In calculating the nexus ratio, only R&D expenditures that are (i) directly connected to the eligible IP asset and (ii) incurred by taxpayers to develop the IP asset can be taken into consideration. In particular, it is proposed that the jurisdictional approach will be adopted in determining the eligible expenditures, which include expenditures on R&D activities:

- Undertaken by the taxpayer inside or outside Hong Kong;
- Outsourced to unrelated parties to take place inside or outside Hong Kong; and
- Outsourced to resident related parties to take place inside Hong Kong.

Acquisition costs of an eligible IP asset are not regarded as eligible expenditures, as they are not considered R&D expenditures.

Eligible IP income

The scope of IP income includes:

- Income derived from an eligible IP asset in respect of the exhibition or use of, or a right to exhibit or use (whether in or outside Hong Kong) the asset;
- Income arising from the sale of an eligible IP asset; and
- Sales price of a product or service that includes an amount attributable to an eligible IP asset.

Concessionary tax rate

The preferential tax rate for the patent box regime is still under consideration. For most of the concessionary tax rates under various preferential tax regimes in Hong Kong, a 8.25% tax rate has been applied. The Hong Kong Government may also take reference of the preferential tax rates adopted by patent box regimes in other jurisdictions (e.g. Luxembourg at 4.99%, Ireland at 6.25%, Israel at 5% to 16%, Korea at 4.5% to 18% and Singapore at 5% or 10%) in determining

the level of concessionary tax rate for Hong Kong in a view of offering a competitive patent box tax incentive.

Treatment of losses

In general, any tax loss associated with the patent box tax incentive should not be allowed to set off against income that is taxed at the ordinary rate. However, if the amount of loss is to be adjusted with reference to the tax rate difference, the off-setting may still be allowed.

Record keeping requirements

Taxpayers would be required to keep sufficient information to track and trace the R&D expenditures and eligible income for calculating the nexus ratio on a cumulative basis. To let taxpayers enjoy the patent box preferential regime even if a detailed record keeping mechanism has not been in place, there would be a transitional measure to allow taxpayers to calculate the qualifying expenditures and overall expenditures on a three-year average rolling basis. After the transitional period, taxpayers would need to calculate the nexus ratio using the cumulative basis.

What's next

The Hong Kong Government is gathering views from the relevant stakeholders on the proposed patent box tax incentive and will take into account the comments in formulating the regime. It is targeted that the relevant Amendment Bill will be introduced into the Legislative Council in the first half of 2024.

Our observations

We do welcome the government's initiative to introduce such patent box tax incentive to further increase Hong Kong's competitiveness as an international innovation and technology centre and a regional IP trading centre. The above proposals are initially developed by the Hong Kong Government, subject to the comments gathered from various stakeholders during the public consultation, further refinement may be made to the proposed patent box tax incentive.

Besides this proposed patent box tax incentive, we look forward to the Hong Kong government considering further enhancements on other IP-related tax rules such as allowing deductions or amortizations on acquisition costs of IP acquired from related parties, broadening the scope of qualifying R&D activities for the enhanced R&D deductions, etc., which are of interests to taxpayers that are considering to move or expand its IP hub in Hong Kong.

Taxpayers should watch out for any latest development and seek professional advice in evaluating any potential opportunities in IP development and trading in Hong Kong under the proposed tax incentive.

If you have any questions, please contact our professionals:

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