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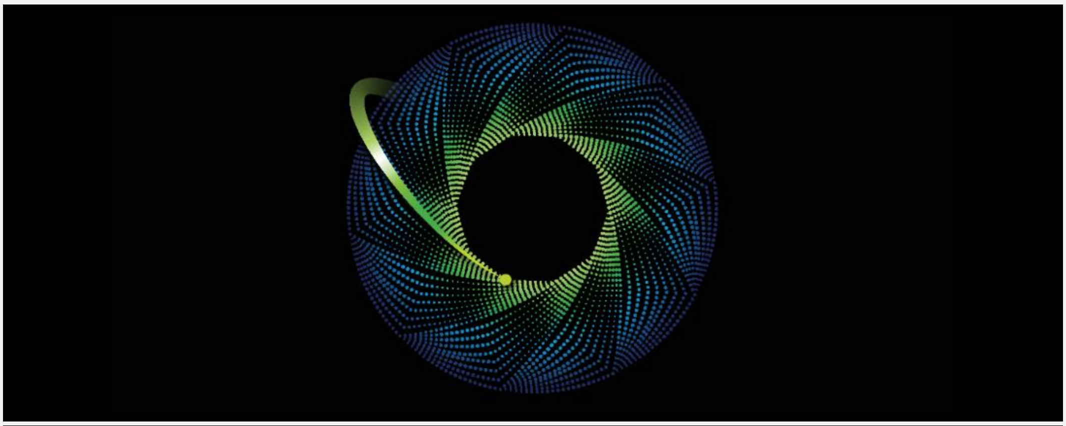
Hong Kong | Tax & Business Advisory | 26 June 2024 | Issue 218



Hong Kong Tax Newsflash
Passage of patent box tax concession

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The draft legislation[1] on the patent box tax concession was passed by the Legislative Council today. It provides a concessionary tax rate of 5% for qualifying profits sourced in Hong Kong from eligible intellectual property (IP) created through research and development (R&D) activities. The patent box tax concession will apply retrospectively to the year of assessment beginning on or after 1 April 2023.

A bills committee was formed to scrutinize the bill prior to its passage. A minor committee stage amendment was made in relation to the period for applying the three-year average rolling basis for calculating the R&D fraction. This amendment is intended to cater for the different accounting year-end dates adopted by businesses.

In this article, we recap the key features of the patent box tax concession and highlight the discussions that took place during the bills committee meetings, where the government clarified several issues pertaining to the tax concession. For the background and details of the tax concession, please refer to our Hong Kong Tax Newsflash [Issue 194](#) and [Issue 214](#).

Key features and clarifications from the government

Eligible IP

Eligible IP means an IP that is generated from R&D activities, including patent, plant variety right[2] and copyrighted software. The government clarified that:

- Copyrighted software refers to a copyright subsisting in software under the Copyright Ordinance of Hong Kong or corresponding foreign laws. Although registration of copyrighted software is generally not required under the Copyright Ordinance or foreign law, it must fall within the scope of the relevant legal protection to be regarded as an eligible IP.

- Due to restrictions on patent registration in Hong Kong, standard patents (re-registration) and their applications will be excluded from the scope of eligible patents if the date of filing is after the expiry of the 24-month period following the commencement date of the Bill.

Eligible IP income

Eligible IP income includes:

- income derived from an eligible IP in respect of the exhibition or use of, or a right to exhibit or use (whether in or outside Hong Kong) the IP;
- income derived from the sale of an eligible IP;
- price of a product or service that includes an amount attributable to an eligible IP (embedded IP income); and
- insurance, damages or compensation derived in relation to an eligible IP.

The government indicated that the tax concession would only apply to IP disposal gains that are revenue in nature, as determined based on badges of trade analysis. Capital gains (i.e. disposal gains on IPs which are capital assets) would continue to be exempt from Hong Kong profits tax[3].

R&D fraction for concessionary portion of assessable profits

R&D fraction is a ratio for determining the portion of assessable profits that could benefit from the preferential tax treatment. It is a fraction of eligible R&D expenditures to overall expenditures related to the IP.

- The government pointed out that only R&D expenditures directly connected to the eligible IP would be considered eligible. For instance, property rental expenditures incurred for R&D activities might be regarded as eligible R&D expenditures.

- Where the taxpayer has undertaken part or all of the underlying R&D activity under a cost sharing arrangement[4] (CSA), the share of R&D expenditure borne by the taxpayer under the CSA can be accepted as eligible R&D expenditure in calculating the nexus ratio (i.e. R&D fraction), provided that other conditions of eligible expenditures prescribed under the OECD's nexus approach are satisfied.

- If the taxpayer obtained an IP or any right vested in a company that is a Hong Kong resident person[5] (original owner) through amalgamation or acquisition of all equity interests in the original owner, the expenditure incurred by the original owner in respect of the IP would be regarded as eligible R&D expenditures. The government clarified that the original owner must be a Hong Kong resident person at the time when the subject IP or any right is or was vested.

Our observations

We are pleased to note the government's clarification on several aspects of the tax concession, especially the confirmation that the share of R&D expenditures under a CSA would be considered as eligible R&D expenditures for the purpose of determining the R&D fraction. These clarifications are crucial for taxpayers to understand the legislative intent of the government and the implementation practices of the Inland Revenue Department (IRD). To facilitate tax compliance, the IRD will issue guidance and illustrative examples on its website.

The patent box tax concession is a significant initiative introduced by the government to foster R&D activities and the creation of IP in Hong Kong. It could be applicable to a broad range of businesses, not just limited to high-tech sectors such as life science and technology. Taxpayers are encouraged to seek professional advice to assess any potential opportunities in benefitting from the patent box tax concession.

Deloitte China will hold a seminar on 9 July 2024 at 2:30pm (HKT) to provide the information of the new patent box tax concession and share practical tips and strategies on how you can leverage this concession to its full potential. Please click here for registration.

[1] *Inland Revenue (Amendment) (Tax Concessions for Intellectual Property Income) Bill 2024*

[2] Plant variety rights are rights granted to the owners of plant varieties over cultivated plant varieties they have bred or discovered or developed.

[3] except foreign-sourced disposal gains, which would be subject to the Foreign-Sourced Income Exemption regime.

[4] A cost sharing arrangement is a contractual arrangement among business enterprises to share contributions and risks involved in the joint development, production or obtaining of intangibles, tangible assets or services with the understanding that such intangibles, tangibles assets or services are expected to create benefits for the individual businesses of each of the participants.

[5] A company incorporated in Hong Kong or, if incorporated outside Hong Kong, normally managed or controlled in Hong Kong.

If you have any questions, please contact our professionals:

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