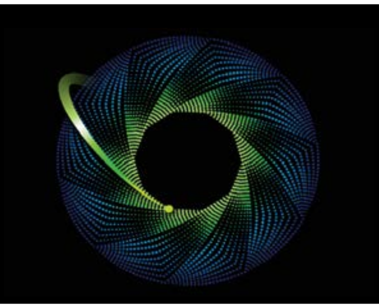

Hong Kong Tax Newsflash
Patent Box regime clarified with new illustrative examples

Hong Kong | Tax & Business Advisory | 19 May 2025 | Issue 241

The Inland Revenue Department (IRD) recently released a comprehensive set of illustrative examples on the Patent Box regime on its website. Hong Kong's Patent Box regime offers a concessionary tax rate of 5% on qualifying profits[1] derived from eligible intellectual property (IP), including patents, copyrighted software, and plant variety rights, generated from research and development (R&D) activities. It was introduced in 2024 and took retrospective effect from the year of assessment 2023/24.

This article will highlight some key examples provided by the IRD, focusing on the applicability of the Patent Box tax concession for common business models, as well as sharing some practical insights. For the details of the regime, please refer to our Hong Kong Tax Newsflash Issue 194, Issue 214 and Issue 218.

Copyrighted software outsourcing model

The IRD provided illustrative examples on the application of the Patent Box tax concession in the context of copyrighted software[2] developed under outsourcing arrangements. In these examples, a Hong Kong manufacturing company engaged a third-party software developer to create a tailor-made software embedded in its finished goods. The software, created through R&D activities, is a copyrighted software.

As the Hong Kong manufacturing company derived embedded IP income from the copyrighted software, it qualifies for the Patent Box tax concession. To claim this concession, the company should use a transfer pricing methodology to determine the portion of income attributable to the value of the copyrighted software.

In contrast, the outsourced developer is generally not eligible to claim the tax concession on the outsourcing service income, as it is not probable that the newly created copyrighted software, at its development stage, would qualify as an eligible IP. However, if the outsourced developer uses its own pre-existing eligible IP to

[1] Profits from eligible income, including:
- 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.

[2] A copyrighted software means a copyright subsisting in software under the Copyright Ordinance (Cap. 528) or under the law of any place outside Hong Kong.

develop the new copyrighted software, it can claim the tax concession on the portion of income derived from the use of that IP, determined based on a transfer pricing methodology.

Our comments: One key consideration for the Hong Kong manufacturing company, however, is the terms of the outsourcing arrangements. Whether the outsourcing arrangements relate to R&D services or for the provision of software-embedded finished goods can materially affect the resulting Patent Box calculation and benefit.

Online game and platform

In the illustrative example on the online game and platform, the company developed a substantially improved online gaming platform and a new game by applying research findings and conducting systematic market research respectively. The IRD considered these activities to be R&D. The new platform and game, being copyrighted software, qualify as eligible IP under the Patent Box regime. As such, the Patent Box tax concession would apply to the concessionary portion[3] of the eligible IP income derived.

Mobile application

The IRD provided examples to illustrate what activities are regarded as R&D activities in the context of mobile application development. In one example, a Hong Kong company developed a new mobile application (version 1.0) as an online shopping platform with a new security technique. The development of this new application involved R&D activities, including systematic market research and applying the research findings. These activities qualify as R&D activities, and the new mobile application, being copyrighted software, would qualify as an eligible IP under the Patent Box regime.

However, subsequent de-bugging and minor improvements to the existing mobile application (version 1.1) do not constitute R&D activities, and thus, version 1.1 does not qualify as an eligible IP.

In contrast, the systematic activities and application of research findings to develop an upgraded mobile application (version 2.0) would qualify as R&D activities, and version 2.0 would be an eligible IP.

Our comments: Taxpayers should be aware of the nature and treatment of different activities performed. The definition of R&D has a very wide scope, but activities deemed to be routine in nature typically do not constitute R&D activities.

In another example provided, an online shopping company developed a copyrighted software that enhanced its online shopping platform and boosted sales. As the copyrighted software was not embedded (i.e. did not include its value) in the goods sold, no portion of the sales income is regarded as eligible IP income.

Our comments: Despite the fact that the copyrighted software may qualify as an eligible IP, no portion of the income from the sale of goods would be regarded as eligible IP income if the software is not embedded in the goods sold. Therefore, taxpayers should consider whether income should be generated through licensing its IP, selling goods with embedded IP, or using its IP to provide services. Structuring their income carefully and conducting transfer pricing studies to ascertain any embedded income helps taxpayers ensure they can enjoy the Patent Box tax concession to its full potential.

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[3] The concessionary portion of the eligible IP income is computed by multiplying the assessable profits from the eligible IP income with the R&D fraction. The R&D fraction is the ratio of eligible R&D expenditure (uplifted to 130%) to the sum of eligible R&D expenditure and the non-eligible expenditure.

Licensee

The illustrative examples demonstrate that a licensee with the right to use an eligible IP for deriving income can be eligible for the Patent Box tax concession, even if it does not own the eligible IP. However, when ascertaining the R&D fraction to determine the concessionary portion of eligible IP income derived by the licensee, the license fee paid to acquire the right to use the IP is considered non-eligible expenditure for the purpose of the R&D fraction. Meanwhile, if the licensee conducts R&D activities to further develop the licensed IP and commercialise any products which are new or substantially improved based on it, the relevant R&D expenditures incurred by the licensee would be considered eligible R&D expenditures. In other words, a licensee can only claim the tax concession if it conducts further R&D activities; otherwise, the R&D fraction and the concessionary portion of eligible IP income would be zero.

Multiple patents within a single product

The IRD addressed complex scenarios involving multiple IPs within a single product. Since the tax concessions under the Patent Box regime are granted in respect of each eligible IP, the eligible IP income derived from each IP and their respective R&D fractions should be ascertained on a just and reasonable basis to compute the concessionary portion of assessable profits from each IP.

Our comments: This means tracking and allocation of IP income and R&D expenditure should be to the level of each individual eligible IP if possible. Nevertheless, according to the Government's earlier response[4] to the stakeholders' comments during the process of legislation, in cases where it is not possible to split the income and attribute specific expenditure to the level of each individual IP, it is allowable to apportion expenditures incurred among different IPs and in turn the relevant R&D fraction, provided the apportionment is just and reasonable.

This example emphasizes the importance of meticulous tracking and allocation of income and expenditure and documenting how the IPs relate to the product(s) when multiple IPs are involved.

Change in outsourcing relationship

Outsourced R&D expenditure paid to Hong Kong associated persons and undertaken in Hong Kong or non-associated persons would be classified as eligible R&D expenditure, while outsourced R&D expenditure paid to overseas associated persons would be classified as non-eligible expenditure. The IRD provided an example to illustrate how the outsourced R&D expenditure is classified when there is a change in the relationship between the taxpayer and the outsourced company. In such cases, the classification of the R&D expenditure before and after the change should be considered separately.

For example, a Hong Kong company engaged an independent overseas company to perform part of its R&D activities starting from 1 July 2024. On 1 September 2024, the Hong Kong company acquired the overseas company as a wholly owned subsidiary. In this example, the service fees paid for July and August, during which the overseas company was not associated with the company, would be regarded as eligible R&D expenditure. However, the service fees paid from 1 September 2024 onwards would become non-eligible expenditure because the overseas company became an associated company.

[4] legco.gov.hk/yr2024/english/bc/bc03/papers/bc03cb1-742-1-e.pdf

Our observations

The IRD's illustrative examples provide essential guidance for Hong Kong businesses seeking to benefit from the Patent Box regime. These examples demonstrate various scenarios, emphasizing the importance of detailed planning, documentation, and compliance. For instance, they highlight the different ways businesses can use IP to derive eligible IP income, the necessity of using appropriate transfer pricing methodologies to determine income attributable to embedded IP, the careful apportionment of income and expenditure when dealing with multiple IPs or shared R&D resources, and the classification of R&D expenditures.

Robust, contemporaneous documentation for all R&D activities, income attribution, and expenditures is crucial. Businesses should meticulously review the IRD's detailed guidance and examples. Seeking professional tax advice for proactive planning is recommended to effectively structure R&D operations, IP ownership and income generation, thereby maximizing potential benefits under the Patent Box regime.

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